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## Whatever's *FAIR*—Adequacy, Equity, and the Underwriting Prerogative in Property Insurance Markets

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By Robert Works\*

# Whatever's *FAIR*—Adequacy, Equity, And the Underwriting Prerogative In Property Insurance Markets

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## IV. RECASTING THE DEBATE: SOME CAUTIONS AND A MODEST PRESCRIPTION

## A. Limitations of the Antidiscrimination Sentiment

## B. Recasting the Debate

*At every point in the history of large corporations there has been some moment of impact on the community when either the community felt the corporation was not fulfilling its obligations or alternatively, the corporation realized it was up against a situation it could not handle. In every case, the result has been either a friendly and orderly, or an unfriendly and disorderly, hassle . . . †*

## I. INTRODUCTION

Insurance regulation in this country, as with the law generally, is more the accretion of specific responses to immediately perceived problems than the product of ordered efforts to achieve fundamental objectives. Governmental concern with the insurance device has grown slowly, without the guidance of integrated theory, and with few decisive junctures to punctuate the otherwise incremental patterns of development.<sup>1</sup> Occasionally, however, events do occur which offer the prospect that a rationally derived agenda of goals might be coupled with at least a fleeting consensus to produce a significant departure from the course suggested by the regulatory system's existing objectives and existing clientele groups. To some, the civil disturbances which racked Newark and Detroit in the summer of 1967 appeared to present such an opportunity. Many of the riot victims were uninsured or underinsured, and the specter of additional riots of unknowable frequency and dimension threatened to precipitate a mass exodus of property insurers from central city areas. With the possibility that crisis might impose what mature reflection would suggest, a special presidential panel was convened.<sup>2</sup> Its recommendations for "Meeting the Insurance Crisis

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† Cleveland, *The Blurred Line Between "Public" & "Private,"* in *ETHICS & BIGNESS: SCIENTIFIC, ACADEMIC, RELIGIOUS, POLITICAL AND MILITARY XIII*, xxvi (quoting Adolf Berle) (H. Cleveland & H. Lasswell eds. 1962).

1. See generally J. HANSON, R. DINEEN, & M. JOHNSON, *MONITORING COMPETITION: A MEANS OF REGULATING THE PROPERTY AND LIABILITY INSURANCE BUSINESS* (1974); S. KIMBALL, *INSURANCE AND PUBLIC POLICY* (1960); E. PATTERSON, *THE INSURANCE COMMISSIONER IN THE UNITED STATES* (1927); STATE OF NEW YORK INS. DEPT., *THE PUBLIC INTEREST NOW IN PROPERTY AND LIABILITY INSURANCE REGULATION* (1969); Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1961).

2. The National Advisory Panel on Insurance in Riot-Affected Areas [hereinafter referred to as the Panel] was formed as an adjunct to the parent National Advisory Commission on Civil Disorders to con-

of our Cities"<sup>3</sup>—essentially, provision of federal reinsurance of the riot hazard to those insurers who participate in approved state efforts to guarantee adequate property insurance markets in urban centers—soon found substantial embodiment in the Urban Property Insurance Protection and Reinsurance Act of 1968.<sup>4</sup> In the opinion of at least one influential observer, the new law was "the most significant insurance legislation adopted in this century."<sup>5</sup>

Any attempt to evaluate the accuracy of this assessment must await a perspective that only additional time can provide. From this vantage, less than a decade into the history of the programs spawned by the federal legislation, the implications of these developments remain elusive. True, the legislation dramatically introduced a potentially important federal institutional presence into what has been primarily a state-based regulatory system.<sup>6</sup> For a

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sider the insurance problems of urban core businessmen and residents. The Panel was chaired by Governor Hughes of New Jersey, and counted among its members former Governor Scranton of Pennsylvania, the Mayor of Washington, D.C., the presidents of a major stock insurance company and a major mutual insurance company, the president of a life insurer with substantial investments in the inner cities, and an Assistant Attorney General of the United States.

3. THE PRESIDENT'S NATIONAL ADVISORY PANEL ON INSURANCE IN RIOT-AFFECTED AREAS, MEETING THE INSURANCE CRISIS OF OUR CITIES (1968) [hereinafter cited as the PANEL REPORT]. The basic findings and recommendations of the Panel are also included in REPORT OF THE NATIONAL ADVISORY COMMISSION ON CIVIL DISORDERS app. G. (1968). The formal hearings conducted by the Panel are reported as THE PRESIDENT'S NATIONAL ADVISORY PANEL ON INSURANCE IN RIOT AFFECTED AREAS, HEARINGS (1967) [hereinafter cited as the PANEL HEARINGS].
4. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (codified primarily as 12 U.S.C. §§ 1749 bbb-1 to 1749 bbb-21 (1970)) [hereinafter referred to as the Federal Act].
5. Denenberg, *The Federal Reinsurance Program*, *BEST'S INS. NEWS* (P & L), Oct. 1968, at 28.
6. Since *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), declared that the business of insurance involved transactions in commerce which could be the subject of federal regulation, and the McCarran Act, 15 U.S.C. §§ 1011-1015 (1970), expressed the congressional decision that continued regulation and taxation by the states was in the public interest, insurance regulation has been embodied in a basically state system whose jurisdiction is dependent upon the continued sufferance of the Congress. The McCarran Act made the Sherman Act applicable to cases of boycott, coercion or intimidation, but provided that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act "shall be applicable to the business of insurance to the extent that such business is not regulated by State law." 15 U.S.C. § 1012(b) (1970).

In fact, of course, the federal government's activities have impinged on the state-based regulatory arrangement in a number of ways. The boundaries of the McCarran Act exemption are continuously being re-



variety of reasons, however, most of that potential for a relocation of regulatory authority continues inchoate. True, also, the programs have written nearly five million property insurance policies that otherwise might not have been placed,<sup>7</sup> and in some states the programs have become the largest writers of property insurance. In other states, however, the programs have died, and it is far from clear that they offer a lasting solution to property insurance availability problems or that they signal any generalized departure from existing regulatory traditions in the name of "availability." Still, if these developments have not unequivocally drawn regulatory authority toward Washington nor wrenched inherited conceptions of regulatory function on to a new course, it is increasingly apparent that they have helped to jar the regulatory system into a period of self-conscious reassessment of some of the fundamental assumptions of insurance regulation.

Importantly, this period of introspection has proved more the product of the Panel's recommendations than of the process by which they were prepared. Although the usual justification for investigatory commissions emphasizes their potential for taking the synoptic view,<sup>8</sup> goals for societal action rarely come neatly labeled

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defined. See generally Sfikas, *The Quality of State Regulation Necessary to Invoke the Insurance Exemption to the Antitrust Laws*, 1973 INS. L.J. 305. Beyond that, nonregulatory federal involvement in a broad range of insurance programs has long been an important indirect influence on the directions of the industry and its regulation. For an able summary of the situation prior to the developments discussed in this article, see Larson, *The Government's Role in Insurance Marketing*, National Underwriter (F & C), Sept. 8, 1967, at 1, col. 1, reprinted in *Hearings on S. 1484 Before the Subcomm. on Small Business of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 19 (1967). The best summary of the interests, values, and judgments implicit in varying allocations of regulatory control to federal and state agencies is Kimball, *The Case for State Regulation of Insurance*, in *INSURANCE, GOVERNMENT, AND SOCIAL POLICY* 411 (S. Kimball & H. Denenberg eds. 1969). For a recent status report, see Johnson, *Insurance Regulation at the Crossroads*, 1977 INS. L.J. 7.

7. BEST'S REVIEW (P & L), Dec. 1976, at 5. Annual insurance in force placed through the Fair Access to Insurance Requirements [hereinafter referred to as FAIR] programs in recent years has exceeded \$16,000,000,000.
8. Compare Bell, *Government by Commission*, PUB. INTEREST, No. 3, Spring 1966, at 3 (extolling the special potential of governmental commissions) with Wilson, *A Reader's Guide to the Crime Commission Report*, PUB. INTEREST, No. 9, Fall 1967, at 65 (outlining the particular constraints which prevent most commissions from offering a "solution" to the "problems" posed). A more comprehensive treatment is provided by A. PLATT, *THE POLITICS OF RIOT COMMISSIONS 1917-1970* (1971). For an extensive bibliography, see Sulzner, *The Policy Process and the Uses of National Governmental Study Commissions*, 24 W. POL. Q. 438 n.3 (1971).

or ranked, and few commissions possess the will or the means to stay long in the business of attempting to reconcile competing interests and objectives. So it was with the Panel. Its role, fully as much as fact finding and policy recommendation, quickly became a frankly political one: to explore and extend the limits of federal action through its consultations with interested groups, and to generate public interest and support for its ultimate recommendations. It viewed its primary function to be to develop an acceptable legislative package. The near unanimity of approval which hailed the Panel Report and the ease with which the implementing legislation attained congressional ratification attested the Panel's success, but they also signaled the limitations of the Report. The need to produce proposals which could accommodate the programs being developed independently by several states and which could be expected to evoke a broad range of support among widely disparate groups inevitably restricted the Panel's attention to the short run and forced it to limn its suggestions with broad strokes. Quickly it became apparent that many read only what they wanted to read in the Report, and that the federal legislation left serious problems of concept as well as detail to be resolved by HUD, state regulatory authorities, and the insurance industry.<sup>9</sup>

This article is an examination of that process, the residual market mechanisms it has produced, and their more significant impacts on the property insurance regulatory system. In many ways this is a case study, and as such it supplies a mixture of the descriptive and the thematic. Throughout, however, its focus is less upon the traditional concerns of case studies of public regulation—developing and testing generalizations about political and administrative behaviors, and determining substantive issues of who gets what—and more upon tracing the evolution of the dominant ideas and habits of thought that have helped to fashion that development. This emphasis not only reflects the conventional assumption that

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9. This is not to suggest that members of the Panel were unaware that implementation of their recommendations would require additional significant decisions. See, e.g., the comment by Panel member Wozencraft: "[T]he Panel's report and [the House bill which eventually was enacted] set forth only the basic operating structure of the FAIR plans. We expect that each State insurance authority will build upon these plans and adopt whatever additional provisions are needed to meet local requirements." *Hearings on H.R. 15625 before the Subcomm. on Housing of the House Comm. on Banking and Currency*, 90th Cong., 2d Sess. 1076 (1968) [hereinafter cited as *1968 House Hearings*]. See also *id.* at 168 (Representative Moorhead, the chief congressional expert, urging that the proposed legislation was too explicit and that more discretion should be left to the states to tailor the programs to local needs).

politically significant belief patterns "shape the boundaries within which policy decisions are reached,"<sup>10</sup> but also applies the reciprocal insight that the content and intensity of attitudes and perceptions are themselves influenced by policy decisions and the vocabularies and processes through which they are made.<sup>11</sup> For these reasons this article does not approach the residual property insurance mechanisms solely as the products of particular episodes of public policy development, to be tested as attempted "solutions" to a defined property insurance "availability problem." Instead they are viewed as temporary accommodations of a complex mix of conflicting interests, values, and perceptions, able to both reflect and affect the way "availability problems" are apprehended and treated by the public, the insurance industry, and public officials.

Central to this perspective is the notion that property insurance availability problems in one important dimension are political problems, and therefore in large part are a function of the language used to define them. The point extends beyond the assumption that the labels individuals and groups attach to their concerns may be a useful index to the interests, attitudes, and perceptions upon which such dissatisfactions are grounded; the discontents provoked by nonprice supply rationing of property insurance draw their public meanings from the language by which they are identified. Thus, as Murray Edelman persuasively argues,

language is an integral facet of the political scene. It is not simply an instrument for describing events, but is a part of events, strongly shaping their meaning and the political roles officials and mass publics see themselves as playing. In this sense, language, events, and self-conceptions mutually define each other.<sup>12</sup>

For this reason, the labels, myths, metaphors, and symbols that facilitate rhetorical reconciliation of conflicting interests and perceptions should not be accepted uncritically as accurate guides to public needs or to likely moves in public policy. Neither should they be ignored, for often they prove to be "an instrument for shaping political support and opposition and the premises upon which decisions are made."<sup>13</sup>

10. Edelman, *Language, Myths and Rhetoric*, Soc'y, July/Aug. 1975, at 14.

11. M. EDELMAN, *POLITICS AS SYMBOLIC ACTION* 68 (1971). See also Bennett, *Political Scenarios and the Nature of Politics*, 8 PHILOS. & RHETORIC 23 (1975); M. SKIDMORE, *MEDICARE AND THE AMERICAN RHETORIC OF RECONCILIATION* ch. 2 (1970). Cf. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. 335, 355 (1974) (discussing possible applications of the economic theory of fraud to attempts to explain the persistence of misleading rhetorical constructs in discussions of regulatory policy).

12. Edelman, *supra* note 10.

13. M. EDELMAN, *supra* note 11, at 68. See also K. BOULDING, *THE IMAGE*:

Thus, one theme that recurs throughout this article concerns the attractions, malleability, and limitations of an antidiscrimination prescription for property insurance problems. The public definition given availability problems by the Panel—"failure to distinguish between good and bad risks in an area regarded as blighted"<sup>14</sup>—initially elicited broad acquiescence because the discrimination diagnosis appeared to tap a central strain in popular perceptions of availability problems, seemed to suggest no marked departures from the usual logic of regulatory concerns, and yet was not inconsistent with efforts by major elements of the insurance industry to invest traditions of industry "voluntarism" and "responsibility" with sufficient content to permit avoidance of publicly defined and imposed limitations on the underwriting discretion of individual insurers. For a time, as we shall see, the contextualization supplied by the Panel's rhetoric of discrimination helped to obscure potentially competing perceptions of the problem and critical points of conflict among those pressed into the programs. Later, as it became increasingly clear that the federal legislation had sealed a bargain made possible by the ambiguity of its terms, and paid for in a currency that was rapidly slipping into disfavor, the discrimination label continued to offer a seductive organizing conception for the interpretation of new pressures and new events, despite the belated efforts of much of the insurance industry to construct and promote an alternative version of the property insurance availability problem. At present, considerable energies are being expended in efforts to establish or to block acceptance of a new incarnation of the antidiscrimination formula as guiding rhetoric for grappling with availability concerns.<sup>15</sup> This article chronicles the origins and political potency of the antidiscrimination conception, and the specific regulatory approach it is said to compel, but concludes that it is of only limited value as an index to the complexities of availability problems in property insurance markets.

Other closely related themes discussed in this article concern the contributions of regulatory institutions and techniques to how availability problems were perceived and to what the residual market programs would be expected to accomplish. Thus, the early identification of "unavailability" as a "regulatory" problem carried

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KNOWLEDGE IN LIFE AND SOCIETY (1965); M. EDELMAN, *THE SYMBOLIC USES OF POLITICS* (1964).

14. PANEL REPORT, *supra* note 3, at 88.

15. *Compare* FEDERAL INSURANCE ADMINISTRATION, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, *FULL INSURANCE AVAILABILITY* (1974) [hereinafter cited as *FULL INSURANCE AVAILABILITY*] with STANFORD RESEARCH INSTITUTE, *THE ROLE OF RISK CLASSIFICATIONS IN PROPERTY AND CASUALTY INSURANCE* (1976).

a range of channeling attitudes. The regulatory mode, after all, is better suited to the assumption of some functions than others,<sup>16</sup> and established regulatory institutions tend to view new demands from the perspective of existing regulatory goals and techniques.<sup>17</sup> Moreover, direct, interdictory regulatory interventions typically are one thing, attempts to induce or coerce improved performances often quite another.<sup>18</sup> In this setting, for a rich mix of reasons, there was a strong inclination to regard unavailability as the product of insurer failings. On the other hand, the existing arsenal of regulatory weapons did not easily accommodate this new and ambiguous "abuse." As a consequence, regulators turned to exhortations and admonitions. This approach meshed well with industry voluntarism designed to avoid any publicly defined limitations on underwriting prerogatives. It gave the appearance of governmental con-

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16. See, e.g., Lowi, *Four Systems of Policy, Politics, and Choice*, 32 PUB. AD. REV. 298, 299 (1972) (suggesting that regulatory techniques carry a "distinct set of moral and political process consequences associated with this kind of governmental commitment"); Lowi, *American Business, Public Policy, Case Studies and Political Theory*, 16 WORLD POL. 677 (1964) (suggesting a seminal taxonomy of political relationships in which the determinative feature is the nature of the policy at stake); L. Froman, *The Categorization of Policy Contents*, in POLITICAL SCIENCE AND PUBLIC POLICY 41 (A. Ranney ed. 1968); R. Salisbury, *The Analysis of Public Policy*, in *id.* at 151 (adding "self regulatory" to Lowi's basic divisions of policy contents into "regulatory," "distributive," and "redistributive" categories). An excellent recent synthesis is provided by Sabatier, *Social Movements and Regulatory Agencies: Toward a More Adequate—and Less Pessimistic—Theory of "Clientele Capture"*, 6 POL. SCI. 301 (1975).
  17. See *Hearings to Study Senate Concurrent Resolution 21 Before a Subcomm. of the Senate Comm. on Labor and Public Welfare*, 82d Cong., 1st Sess. 224 (1951), reprinted in L. HAND, *THE SPIRIT OF LIBERTY* 241-42 (3d ed. 1960) (Judge Learned Hand criticizing the tendency of regulatory institutions to "fall into grooves, just as the judges are so apt to do"; he concludes, "And when they get into grooves, then God save you to get them out of the grooves."). See also D. TRUMAN, *THE GOVERNMENTAL PROCESS* 467-68 (1951).
  18. I. A. KAHN, *THE ECONOMICS OF REGULATION* 18 (1970); PERFORMANCE UNDER REGULATION (H. Trebing ed. 1971).

Inherently, regulation is lacking in precise standards, either automatic or scientifically contrived. This defect is far from fatal. The one inherent weakness, however, which may prove fatal, is that regulation is essentially a restrictive rather than a positive promotional instrument. It can restrain, as does competition, but it cannot promote as does competition. Only the threat of public ownership will suffice to improve performance. It can offer inducements for performance but it has no direct power to enforce it or insure it.

Lewis, *Emphasis and Misemphasis in Regulatory Policy*, in *UTILITY REGULATION* 212, 245 (W. Shepherd & T. Gies eds. 1966).

cern without the need to specify a coherent vision of availability problems or to test the accuracy of doubts concerning the ability of regulatory initiatives to improve industry performance. Eventually, as we shall see, this attitude became a part of the Panel Report and the federal legislation. By making the shared responsibilities and parceled authority of "creative federalism" the guiding administrative approach for the programs, the Panel sought to avoid the disturbance of existing patterns of state and federal regulation, and even the appearance of coercive regulation itself. The price was high.<sup>19</sup> The diffusion of authority over the course of the programs made the residual market mechanisms impervious to effective public control. Moreover, it produced a lack of standards concerning two of their central dimensions—coverage and price, and a siphoning of industry and regulatory resources into rationalizing differential impacts of the programs on their participants. As a result, issues that might have been viewed as primarily actuarial and administrative instead have been framed increasingly as problems of unjustified insurer discrimination, with consequent pressures for remedial action in keeping with that perspective, and with the added effect that other aspects of availability problems largely have been screened out of public consideration and debate.

Examination of this process and of the residual market mechanisms it has produced is especially appropriate at this time. "Availability problems" in a variety of insurance markets are asserting claims for regulatory attention. The temptation to respond to such demands with the attitudes and arrangements developed in the property insurance context—as though the administrative struc-

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19. Theodore Lowi's description of "interest group liberalism" captures much of the motivation and many of the costs of this approach:

Government is obviously the most efficacious way of achieving good purposes in our age. But alas, it is efficacious because it is involuntary. To live with their ambivalence, modern policymakers have fallen into believing that public policy involves merely the identification of the problems toward which government ought to be aimed. It pretends, through "pluralism," "countervailing power," "creative federalism," "partnership," and "participatory democracy" that the unsentimental business of coercion need not be involved and that the unsentimental decisions about how to employ coercion need not really be made at all. Stated in the extreme, the policies of interest-group liberalism are end-oriented but ultimately self-defeating. Few standards of implementation, if any, accompany delegations of power to administrators. The requirement of standards has been replaced by the requirement of participation. The requirement of law has been replaced by the requirement of contingency. As a result the ends of interest-group liberalism are mere sentiments, therefore not really ends at all.

T. LOWI, *THE END OF LIBERALISM* 85 (1969).

tures evolved there were neutral techniques that somehow could be divorced from the special mix of history that produced them—is not easily resisted.

The programs themselves warrant attention. The early 1970's were generally favorable financial years for most property insurers, with consequent reductions in the pressures on residual property insurance programs. In mid-decade, though, a combination of adverse underwriting results in standard property insurance markets and reserve positions shrunk by stock market reverses made questions that had lain dormant for several years appear more pivotal. The Federal Insurance Administration has declared the approach embodied in existing residual property programs to be fundamentally unsound and, despite the resistance of substantial elements of the insurance industry, has been urging the adoption of its "Full Insurance Availability" proposals as the basis for their replacement.<sup>20</sup> At the same time, opposition to renewal of the federal legislation has surfaced in several quarters,<sup>21</sup> and another federal agency has prescribed a restructuring of the regulation of the property-casualty insurance industry that appears to include attitudes toward residual market programs dramatically at odds with those espoused by the Federal Insurance Administration.<sup>22</sup> Clearly, then, the debate is not yet ended; the struggle to influence how availability problems will be perceived and treated continues.<sup>23</sup> An elab-

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20. FULL INSURANCE AVAILABILITY, *supra* note 15.

21. See, e.g., Insurance Advocate, Feb. 7, 1977, at 5, col. 1 (report of disagreements between National Association of Independent Insurers and American Insurance Association in testimony before Senate Banking Committee).

22. UNITED STATES DEPARTMENT OF JUSTICE, REPORT OF THE TASK FORCE ON ANTITRUST IMMUNITIES (1977), reprinted in ANTITRUST & TRADE REG. REP. (BNA) ¶ I-8 (Jan. 18, 1977). The task force recommends establishing a system of federal chartering for insurers. Insurers could then opt to continue under state charter within the McCarran Act exemption, or seek a federal charter and lose the exemption. However, a state role would remain. Federally chartered insurers would be subject to state requirements that insurers participate in residual market plans; states could "regulate the rates charged by federally-chartered companies provided they were administered on a self-sustaining basis. In lieu of cross-subsidization . . . the state could furnish a direct 'external' subsidy to individuals who could not afford insurance protection." *Id.* ¶ I-9. As we shall see, the funding proposal of the Justice Department task force is quite different than the approach advocated in FULL INSURANCE AVAILABILITY, *supra* note 15.

23. Professor Schattschneider's comment is apt in this setting:

Political conflict is not like an intercollegiate debate in which the opponents agree in advance on a definition of the issues. As a matter of fact, the definition of the alternatives is the supreme instrument of power . . . . He who determines what politics is about runs the country, because the definition

oration of the origins of the programs and the ideas and interests that have contributed to the way they have developed may help to increase understanding of both the problems and the programs and may supply a framework that will clarify some aspects of the current debate.

## II. AVAILABILITY PROBLEMS: A PRELIMINARY EXCURSUS

As with any social problem of broad impacts, the property insurance "availability problem" is a synthetic one—an organizing label which abstracts its core from a number of discontents provoked by restricted supplies of property insurance.<sup>24</sup> The disparities between perceptions of what is and expectations of what ought to be are defined and redefined in property insurance, as elsewhere, by the individuals and institutions who feel their impacts and by those who study them.<sup>25</sup> Thus, to those concerned with stimulating

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of the alternatives is the choice of conflicts, and the choice of conflicts allocates power. It follows that all conflict is confusing.

E. SCHATTSCHNEIDER, *THE SEMI-SOVEREIGN PEOPLE* 68 (1960).

24. The perceptions following the 1967 riots are exhaustively collected in *PANEL HEARINGS*, *supra* note 3. See also *PANEL REPORT*, *supra* note 3; Pfeffer, *The Social Responsibility of Insurance: A Case Study at Watts*, 34 *J. RISK & INS.* 525 (1967).
25. The Panel Report eschewed any attempt to provide a precise official definition of availability problems in favor of constructing a syndrome of its more apparent characteristics. On the intellectual and institutional constraints supporting this approach, see Marris, *The Concept of Social Problems: Vox Populi and Sociological Analysis*, 21 *SOC. PROBS.* 305 (1974). Professor James Q. Wilson has made some of the same points in characteristically colorful fashion: "If enough people don't like something, it becomes a problem; if the intellectuals agree with them, it becomes a crisis, any crisis must be solved; if it must be solved, then it can be solved—and creating a new organization is the way to do it." Wilson, *The Bureaucracy Problem*, 6 *PUB. INTEREST* 3, 6 (1967). Compare Miller, *The Political Economy of Social Problems: From The Sixties to The Seventies*, 24 *SOC. PROBS.* 630 (1976) with R. MERTON & R. NISBET, *CONTEMPORARY SOCIAL PROBLEMS* (3d ed. 1971).

Adoption of this concept of property insurance availability problems means that this article will make no attempt to treat availability concerns as a dysfunction from some paradigm optimal state of affairs. For representative efforts of this latter sort, focusing chiefly on the welfare economics of medical care insurance, see Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 *AM. ECON. REV.* 945, 961 (1963) (in which Arrow offers the general assertion: "The welfare case for insurance policies of all sorts is overwhelming. It follows that the government should undertake insurance in those cases where this market, for whatever reason, has failed to emerge."); Lees & Rice, *Uncertainty and the Welfare Economics of Medical Care: Comment*,



redevelopment of decaying urban centers, the property insurance availability problem has been to short circuit the degenerative spiral that results when construction and rehabilitation starts are dependent on credit, credit is dependent on property insurance, and property insurance is "unavailable." To property insurers, availability problems have been an embarrassment of poor public relations, hostile insureds and producers, and vague fears of potential governmental displacement. To producers, availability problems have meant terminated or restricted relations with insurers, reduced autonomy and increased expenses, and a crisis of customer confidence. To insureds and prospective insureds, availability problems have been felt as cancellations, refusals to renew, low coverage limits, and outright refusals to insure, all imposing their own toll in reduced business opportunities and constricted economic and personal security. For all, though the nuances of diverse impacts might produce quite different perceptions, availability problems in property insurance markets have involved in some manner nonprice supply rationing of property insurance coverage.

How are such persistent "shortages" to be explained?<sup>26</sup> Explanations are necessary, because a large service industry that insists

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55 AM. ECON. REV. 140 (1965); M. PAULY, *MEDICAL CARE AT PUBLIC EXPENSE* chs. 1-3 (1971) (emphasizing the limitations which the presence of moral hazard may impose on Arrow's welfare proposition). From a similar tradition and perspective are Spence & Zeckhauser, *Insurance, Information, and Individual Action*, 61 AM. ECON. REV. PAPERS & PROC. 380 (1971); Zeckhauser, *Risk Spreading and Distribution: A Case Study of the Tradeoff Between Risk Spreading and Appropriate Incentives*, 2 J. ECON. THEORY 10 (1970); Mossin, *Aspects of Rational Insurance Purchasing*, 76 J. POL. ECON. 553 (1968); Smith, *Optimal Insurance Coverage*, 76 J. POL. ECON. 68 (1968).

26. General models of the insurance risk selection process have made few appearances in economic literature. Two significant recent efforts, both concerned primarily with automobile insurance markets, are Smallwood, *Competition, Regulation, and Product Quality in the Automobile Insurance Industry*, in *PROMOTING COMPETITION IN REGULATED MARKETS* 241 (A. Phillips ed. 1975); and Joskow, *Cartels, Competition and Regulation in the Property-Liability Insurance Industry*, 4 BELL J. ECON. & MGT. SCI. 375 (1973). Both reflect the growing recognition that simple determinative economic models do not demonstrate the power that search theories display as potential explanations of underemployed resources and similar market phenomena. While the large recent economic literature seeking to incorporate notions of imperfect and assymetric information is mostly at the level of formal theory, so that there is no assurance that it has much to say about actual markets, many of its insights match those prevalent in the insurance industry for years, and thus seem to provide a useful perspective for viewing the risk selection process. See, e.g., Rothschild & Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976); Hersh-

on selecting to whom it will sell at the consumer level is not a familiar phenomenon. Several important contributors are implicated. In part, the failure of property insurance markets to achieve a market-clearing equilibrium can be seen as a function of inadequacies of regulatory and rating practices inherited from an era of cartelization and as yet only partially accommodated to the new realities of competitive insurance markets. In part, the failure may be attributed to intrinsic limitations of the insurance technique when practiced by competing insurers in an unruly world of heterogeneous property risks of uncertain independence and questionable spread. In part, also, the failures may be understood as the normal consequence of the uncertainty, transaction costs, and incomplete information that characterize real markets unprotected by the simplifying assumptions necessary for the elegant mechanics of economic theory.

### A. Price Controls

The orthodox wisdom in the insurance industry—at least that displayed for public consumption—for many years has been quick to ascribe primary responsibility for availability problems to the constricting influence of the “prior approval” variety of rate regulation. “Every risk is insurable at a price,” runs the old insurance saw, and that refrain has enjoyed a continued currency that reflects its foundation in the simple, determinative, economics of market clearing quantities and prices, and the seductive simplicity of the conclusions it can be made to suggest. As serious guide to the property insurance availability problem, the aphorism is severely incomplete, but its emphasis is not misplaced.<sup>27</sup> Undoubt-

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leifer, *Where Are We in the Economics of Information?*, 63 AM. ECON. REV. 31 (1973); Rothschild, *Models of Market Organization with Imperfect Information: A Survey*, 9 J. POL. ECON. 1283 (1973), and authorities cited therein. More traditional is STANFORD RESEARCH INSTITUTE, *supra* note 15.

27. For an early explanation from the industry perspective see Isaacs, *The Challenge of Risks of Inferior Quality*, 14 CPCU ANNALS 239 (1960), and Cline, *Inadequate Rates—The Main Obstacle to Public Relations*, 19 CPCU ANNALS 113 (1966). On price control induced shortages generally, see A. ALCHIAN & W. ALLEN, *UNIVERSITY ECONOMICS* 92-94 (2d ed. 1967). For an application to fire insurance availability problems in urban core areas, see Syron, *Administered Prices and the Market Reaction: The Case of Urban Core Property Insurance*, 28 J. FINANCE 147, 155 (1973) (“The insurance availability problems of core areas seem to be the result of a normal market reaction to an artificially low price ceiling”). See also Launie, *The Supply Function of Urban Property Insurance*, 36 J. RISK & INS. 269 (1969); Allen, *The Supply Function of Urban Property Insurance: Comment*, 37 J. RISK & INS. 459 (1970).

edly, the prior approval laws and the practices they validated have been important contributors to property insurance availability problems.

Enacted in most states in the wake of *United States v. South-Eastern Underwriters Association*<sup>28</sup> in order to immunize concerted ratemaking from the federal antitrust laws, the prior approval rating statutes codified the then-dominant prescriptions of the cartel. They required property insurance to be treated as a monopoly, competition to be limited to service competition, and property insurance rates to be uniform and predicated strictly on costs. Even after the hegemony of the cartel had been broken by deviating and independent stock companies and dividend-paying mutuals, the regulatory lag built into the prior approval system proved compulsion enough to ensure that most insurers would retain their traditional preoccupation with underwriting account quality rather than price. In an industry with relatively low fixed costs, where both inherited conceptions of function and procedural barriers made tailoring price to fit risk an unlikely alternative, insurers were free to vary the selectivity of their underwriting programs whenever they thought the essentially backward-looking prior approval arrangement to be insufficiently responsive to changing loss patterns and the effects of inflation.<sup>29</sup> In this manner, delays in rate increases could contribute to inadequate rates, which could lead in turn to disinvestment in the insurance enterprise and a restricted supply of property insurance.<sup>30</sup> The recent movement to substitute variations of "open competition" rating laws for the existing pattern of prior approval statutes has gained much of its impetus from heightened appreciation of these realities.

Nevertheless, however powerful the inclination to attribute shortages to price controls, property insurance availability problems cannot be dismissed solely as manifestations of the excess demand that predictably results when an artificial price ceiling keeps the market in a state of disequilibrium. A commercial insurer's willingness to assume risks ultimately rests on its confidence in its ability both to predict the degree of hazard it is being asked to assume and to establish a desirable relationship between that risk

28. 322 U.S. 353 (1944).

29. See generally J. HANSON, R. DINEEN, & M. JOHNSON, *supra* note 1, at 73-75.

30. *Id.*; STATE OF NEW YORK, REPORT OF THE SENATE STANDING COMMITTEE ON INSURANCE FOR INVESTIGATION, STUDY AND RESEARCH OF VARYING FIRE INSURANCE RATES 76-77 (Legis. Doc. No. 8, 1967); STATE OF NEW YORK INSURANCE DEP'T, REPORT OF THE SPECIAL COMMITTEE ON INSURANCE HOLDING COMPANIES (1968); Sichel, *Fire Insurance: Imperfectly Regulated Collusion*, 33 J. RISK & INS. 95 (1966).

and the premium to be charged. An orthodoxy that trains attention on the influence of the rate regulatory mechanism on the second of these concerns is an oversimplification<sup>31</sup> that can obscure that other important frictions and rigidities in the pricing and underwriting foundations of the insurance enterprise are likely to persist regardless of the character of the rate regulatory program employed.

## B. Selectivity and the Pragmatic Science

The pricing and underwriting traditions of commercial property insurers are neither as precise nor as arcane as both defenders and critics of them might suggest. Most property insurance pricing involves a rather familiar process of flexible mark up over anticipated average loss costs, with regulatory constraints, demand considerations, and the price posture of competing insurers exerting at least a potential influence on the price selected. The complexities of the process result chiefly from the difficulties of determining with a reasonable degree of confidence the anticipated loss costs of the risks to be assumed. Application of the insurance technique does not allow an insurer to reduce its uncertainty concerning the loss potential of a particular risk, but by proper application of the theory of sampling, an insurer may expect to achieve acceptable predictive power concerning the aggregate losses likely to be experienced by a large number of reasonably homogeneous risks. In theory, an insurer can examine classified data concerning the loss experience of similar risks in the past, amend those data by the application of projection factors, and develop a statement of probabilities of loss that can be used to calculate the dollar amount of premiums necessary to cover expected losses of the sample of risks selected. By controlling the randomness and size characteristics of the sample, the insurer can hope to vary the probability that average loss cost will deviate within the acceptable limits from the average loss cost of the universe of risks from which the sample was chosen.<sup>32</sup>

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31. Unfortunately, some analyses seem not to get beyond the delusive truism that, other things being equal, the higher the permitted rate for the "average" risk within a rating class, the fewer identifiable subclasses will be refused by the rational insurer. But, of course, according to accepted rating principles, many risks would be paying too much for insurance and insurers would be earning greater returns than would be justified by pricing homogeneous subclasses of risks according to their own expected losses.
  32. Descriptions of this process are legion. Especially useful are G. HARTMAN, *RATEMAKING FOR HOMEOWNERS INSURANCE* (1967); I. PFEFFER, *INSURANCE AND ECONOMIC THEORY* (1956); and Houston, *Risk, Insurance, and Sampling*, 31 J. RISK & INS. 511 (1964).

The illusion of statistical rigor dissolves when one considers "the problem of application—are the inferences derived from the model valid for the universe under study?"<sup>33</sup> For almost all insurance this "fit" is very imperfect; the heterogeneity, relatively high values and conflagration potential of property insurance risks, and the uncertainties associated with establishing the causes of property losses, make the requirements of sampling theory exceptionally difficult to satisfy in the property insurance context. By establishing and enforcing underwriting rules of insurability, the insurer attempts to increase the likelihood that the portfolio of risks to be written will adequately approximate the assumptions implicit in the sampling formula. Nevertheless, judgment and intuition play a central role in insurer underwriting and rating decisions, and property insurance especially remains far more a "pragmatic than an exact science."<sup>34</sup>

### 1. *The Limits of Classification*

Insurance exists partly because it is impossible to price accurately the degree of hazard posed by most individual risks; it is equally impossible, of course, to devise insurance categorizations that produce the truly homogeneous classes that sampling theory presupposes. Messy reality can be wrestled into homogeneous categories only by a process of abstraction that defines certain risk attributes as relevant and others as irrelevant. Regardless of their numbers and the skill with which they are chosen, the selection of class-defining risk indicia produces a classification scheme that is inevitably imperfect and value-laden. As Alfred Kahn has wisely noted of classifications in another context: "All raise problems of enforcement; all involve complex distributional effects; all will be economically imperfect, and all will inevitably raise noneconomic questions about what is fair, politically acceptable, and so on."<sup>35</sup>

In property insurance, the classification problem has been handled in a distinctive fashion. Property insurance hazards traditionally have been thought to present the property insurer with

33. I. PFEFFER, *supra* note 32, at 60. See also *id.* at 181-85.

34. C. KULP & J. HALL, *CASUALTY INSURANCE* 11 (4th ed. 1965). See generally Parker, *Ratemaking in Fire Insurance*, in *PROPERTY & LIABILITY INSURANCE HANDBOOK* ch. 13 (J. Long & D. Gregg eds. 1965); R. RIEGEL & J. MILLER, *INSURANCE PRINCIPLES & PRACTICES* ch. 28 (5th ed. 1966); I. PFEFFER, *supra* note 32, at 183-85 (emphasizing the paramount position of "judgment" and the limited validity of the sampling process as the basis for insurers' estimates of risk).

35. I. A. KAHN, *supra* note 18, at 188.

a loss probability continuum that usually cannot be subdivided into discrete classes that will be both acceptably homogeneous and large enough to allow credible classified loss experience to be developed.

In property insurance, the expected amount of loss will vary according to so many factors—occupancy, constructional features, fire protection facilities, size of risk, etc.—that it is nearly always impossible to develop a classification scheme that will subdivide our data into practical homogeneous groups. The finer we classify our data the nearer we approach homogeneity, but the smaller the amount of data in each group: What we gain in homogeneity we lose in credibility of our loss experience.<sup>36</sup>

For some property risks, chiefly dwellings and small apartments,<sup>37</sup> the conflict between the competing demands of homogeneity and credibility has been resolved in favor of extremely broad rating classifications. Because the cost of inspections necessary for more specific rating looms large in relation to the premiums likely to be generated, no effort is made to differentiate between these "class-rated" risks beyond broad fundamental groupings based on the nature of the occupancy, the type of construction, and the rating given local fire protection facilities. No inspection is made, and the age and the physical condition of the property do not affect the rate. Thus,

under class rating, a new one-family frame house in a modern section of Queens is subject to the same fire insurance rate as a fifty-year old one-family frame house in the Bedford-Stuyvesant section of Brooklyn; similarly, a new brick luxury apartment building which is eligible for class rating in the Riverdale section of the Bronx is subject to the same class rate as an old law brick tenement in Harlem.<sup>38</sup>

For most other property risks, the range of loss probability usually has been considered too great to permit direct application of such broad averaging in determining the rate. The answer, however, has not been to refine the classifications and enlarge their number by using additional class-defining risk attributes. Instead,

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36. Longley-Cook, *Notes on Some Actuarial Problems of Property Insurance*, XLVI CAS. ACTUARIAL SOC'Y PROC. 66, 67 (1959), reprinted in *FIRE INSURANCE RATEMAKING AND KINDRED PROBLEMS* 88 (Cas. Actuarial Soc'y 1960).

37. R. RIEGEL & J. MILLER, *supra* note 34, at 566, indicates that class rates usually have been applied to "dwellings, churches, small apartments, farms, clubs, schools, and sometimes small mercantile and special risks," and estimates that such risks constitute approximately 80% of insurable risks in urban areas, producing less than 25% of total premium volume.

38. NEW YORK STATE DEP'T OF INSURANCE, *FIRE INSURANCE IN CONGESTED AREAS* 8 (1967) [hereinafter cited as *FIRE INSURANCE IN CONGESTED AREAS I*].

the basic broad classifications are retained, but periodic rate survey inspections are conducted to permit modification of the average rate by a series of uniform charges for specific deficiencies and uniform credits for superior conditions or the presence of protective devices. These schedules of credits and charges are elaborate statements of quantitative ratios that are supposed to express the relative loss probabilities of the various risk characteristics to which charges and credits have been assigned. The relationships remain fixed even though they never have been validated statistically; they are founded solely on engineering analysis of the hazards presented. Classified experience is used only to adjust the base rate.<sup>39</sup>

The rough approximations of this rating arrangement would pose no problem if all property insurance were supplied by a monopoly fund immune from entry by competitors and insulated from any criticisms premised on concerns for equity and fairness in the rating structure. Under these protective assumptions the need for classification itself would be eliminated. The fund would be free to ignore all differences in perceived cost potentials and to set a single price for all risks calculated to produce whatever total revenues were deemed necessary.

When the assumptions are relaxed, the vulnerability of the property insurance rating approach becomes evident. Common sense observations drawn from everyday experience often indicate that the class rating approach is guilty of an over-inclusiveness that lumps together many risks that appear to present markedly differing cost potentials. Although schedule rating may avoid this criticism, its schedules of charges, based on engineering judgments little changed since 1893 and 1901, in many respects are inconsistent with conventional modern insights and intuitions about contributors to property losses.<sup>40</sup>

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39. McIntosh, *The Rationale of the Fire Schedule—Part I, Theory*, 13 CPCU ANNALS 1 (1960); Longley-Cook, *supra* note 36, at 67; R. RIEGEL & J. MILLER, *supra* note 34, at 571-80. Schedule rating admits numerous variations. The Universal Mercantile System, developed in 1892, in some form is employed in roughly half the states—the Dean Analytic System is used in the remainder. For a simple summary of the principal characteristics of each, see *id.* at 572-78.
  40. Thus, the criticisms go beyond the "empirical distortion to be found in all actual schedules." McIntosh, *The Rationale of the Fire Schedule—Part II, Application*, 13 CPCU ANNALS 117 (1960). For example, Brockmeier criticizes the Dean Schedule for emphasizing structural and exposure elements of fire hazard, and limiting its concerns with occupancy characteristics primarily to factors involving combustibility and damageability, with little effort to recognize conditions likely to be the causes of fires. Brockmeier, *Residual Markets and Fire Insurance Rating*, 25 CPCU ANNALS 41, 47-48 (1972). See also T. ALLEN

In the past, such complaints about the inequity of the property insurance rating formulae usually have been rebuffed by arguments drawing on concerns for credibility,<sup>41</sup> administrative feasibility,<sup>42</sup> and the costs of developing alternative arrangements.<sup>43</sup> However,

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& R. DUVAL, PROPERTY INSURANCE RATING: A PLEA FOR CHANGE (1973); R. RIEGEL & J. MILLER, *supra* note 34, at 591-93; Duke, *Property Insurance Rating, and The Logic of Chance*, 19 CPCU ANNALS 361 (1966).

Importantly, the creators of the schedules held no illusions about their precision; thus A.F. Dean admitted that "[a]ll of those charges, though they embody the combined experience and judgment of practical underwriters, are arbitrary." A. DEAN, *THE RATIONALE OF FIRE RATES* 55 (1900). They nonetheless constituted a marked improvement, he argued, for the substitution of a schedule for the unfettered judgment of the producer meant that, at least, "[e]ach of these charges is as fair for one as for another." *Id.*

41. "It may well be that fire loss expectancy for other than trivial losses may be of such a low order that a fire rating system based solely on loss statistics may not prove feasible within the normal tolerances for credibility standards." Hurley, *Review of Paper on The Probability of  $A = M/N$  by Henry K. Duke*, 15 CPCU ANNALS 187 (1962). In a similar vein, Kenneth McIntosh speaks of "the actuarial core of any fire rating problem: The fire rate structure must be (or, at least, for generations, by custom and usage, has been) refined far beyond the requirements of the fire statistical plan . . . . [F]urther refinement of the statistical plan is no answer of itself because, very simply, of credibility considerations." McIntosh, *A Mathematical Approach to Fire Protection Classification Rates*, 52 CAS. ACTUARIAL SOC'Y PROC. 52 (1965). See also Hurley, *A Credibility Framework for Gauging Fire Classification Experience*, in *FIRE INSURANCE RATEMAKING AND KINDRED PROBLEMS*, *supra* note 36, at 122. Nevertheless, others have urged the possible applicability of multiple correlation analysis as at least a partial means of reducing this problem to manageable proportions. See, e.g., McGuinness, *Review of "The Rationale of the Fire Schedule,"* 14 CPCU ANNALS 83 (1971).
42. "Presented with the impracticability of developing useful expected amount of loss figures, for property insurance, we cannot develop pure premiums, and a completely different method of rate making has to be employed." Longley-Cook, *supra* note 36, at 89.
43. "There are countless obstacles to a schedule rating plan [for dwelling risks], including the need for many additional classifications, and the lack of a realistic solution to the problem of underinsurance, especially on contents exposure. However, the basic objection is to the prohibitive expense involved, and any other criticisms become unimportant." Cotter, *An Evaluation of Present and Alternative Dwelling Rating Methods*, 10 CPCU ANNALS 98, 101 (1958). See also R. RIEGEL & J. MILLER, *supra* note 34, at 585-87 (discussing a "pure premium" method for deriving rates based on collection of classified data by location, occupancy, coverage amount, contract term, building grade, occupancy grade, internal exposure, external exposure, etc., and cost barriers to its realization). In recent years, the advent of electronic data processing has reduced some of the difficulties, and the Insurance Services Office apparently has made some limited initial steps toward increased



the compulsions of competition are not so easily slipped. The property insurance underwriter knows well the dangers of indulging an assumption that the anticipated average loss costs for any classification of property insurance risks will be indicative of the anticipated loss costs for particular risks within that group where the insurer cannot expect to write the entire group of risks. Yet the individual insurer usually cannot expect to develop rating approaches more refined than those provided by the rating bureaus; the constraints of cost, credibility and administrative feasibility are real enough. Instead, in a competitive property insurance market, an insurer will feel compelled to attempt through its underwriting procedures to extend the classification of risks beyond that contemplated by rating procedures so long as it believes that the administrative costs of selective underwriting will be less than the marginal revenues that will result from increased underwriting selectivity. If it believes that loss potentials likely are a function of factors other than those used to characterize the rating class, as it almost always will, it must consider the practicability of recognizing those additional features in its underwriting procedures, even if it believes that the rate would be adequate for all risks within the classification if the insurer could write all or a true sample of such risks.<sup>44</sup> The reason is apparent. By successfully employing a selective underwriting program that increases the quality of the risks that an insurer writes in a classification, the insurer can lower its loss costs, reduce the rates it is able to charge, and achieve first choice of the risks available. If an insurer does not couple selective underwriting with price reductions it will eventually discover that the cream is being skimmed from the classification by other insurers with more aggressive underwriting policies and that it is writing an adverse selection of risks with higher than average loss potential.<sup>45</sup>

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collection of classified property loss experience. See Insurance Advocate, July 26, 1975, at 4, col. 2 (report of Insurance Services Office's pilot project to develop a countrywide commercial fire rating schedule, and companion project to develop a simpler fire class rate manual for small mercantile and service occupancy risks).

44. Moreover, loss potentials are not the only concern; the insurer also must be concerned about the adequacy of the expense portion of the premium. For that reason, low valued risks are unlikely to be attractive to insurers. Traditional rating and pricing techniques make the premium a simple multiple of the rate, so that transaction costs associated with writing a low valued risk will be a much larger proportion of the total premium than would be the case for high valued risks. See generally Buffinton, *The Low Valued Risk—A Study of the Premium Required for Habitational Risks of Various Policy Amounts*, 49 CAS. ACTUARIAL SOC'Y PROC. 119 (1962).

45. See generally Bailey, *Any Room Left for Skimming the Cream?* 47

## 2. Capacity: The Need for Spread

Thus, some selective underwriting practices are a natural concomitant of competition among insurers faced with a spectrum of heterogeneous risks. Other underwriting restrictions reflect the insurer's attempt to satisfy its need for spread. No matter how effectively an insurer's underwriting procedures may permit it to differentiate among property insurance risks on the basis of their inherent loss potentials, the insurer still must be wary of the problem of random variations in that experience. This, rather than limited capital and surplus to back up risks assumed, is the practical capacity problem for most property insurers.<sup>46</sup> The laws of large numbers offer the individual insurer an advantage in coping with uncertain incidence and magnitude of losses only if the individual insurer can achieve sufficient spread in its own portfolio to justify the fundamental assumption of insurance theory—that the rates of the standard deviation to the mean will be reduced as the number of

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CAS. ACTUARIAL SOC'Y PROC. 30 (1960); Dykhous, *Underwriting Regeneration: Restructuring Our Property Insurance Markets*, 14 N.Y.L.F. 795, 800-02 (1968). Cf. Witt, *Pricing and Underwriting Risk in Automobile Insurance: A Probabilistic View*, 40 J. RISK & INS. 509 (1973); Witt, *Pricing Problems in Automobile Insurance: An Economic Analysis*, 40 J. RISK & INS. 75 (1973); Joskow, *supra* note 26; Smallwood, *supra* note 26.

46. Traditional perspectives toward capacity questions have assumed that the capital and surplus posture of the insurer will be the primary determinant of its capacity. In part this may reflect the primacy of solvency concerns, which often employ rules of thumb for gauging "safe" ratios between surplus and premium volume. See, e.g., R. KENNEY, *FUNDAMENTALS OF FIRE AND CASUALTY STRENGTH* (4th ed. 1967) (arguing the "Kenney Theory" that unearned premiums should be kept roughly equal to policy holders' surplus for property insurers); STATE OF NEW YORK INS. DEP'T, *REPORT OF THE SPECIAL COMMITTEE ON INSURANCE HOLDING COMPANIES* 27-29 (1968) (worrying about capacity effects of non-insurance uses of insurers' "surplus surplus"). In part, also, it may reflect arguments predicated on industry-wide capital and surplus structures. See, e.g., Otto, *Capacity*, 28 J. RISK & INS. 70 (1961); Dykhous, *supra* note 45, at 802-05.

Both perspectives provide useful insights into availability concerns, but from the vantage of the individual insurer it seems that "capacity is more usefully viewed as a problem in corporate operating stability than as a problem in capitalization." Stone, *A Theory of Capacity and the Insurance of Catastrophe Risks (Part I)*, 41 J. RISK & INS. 231, 232 (1973). See also Stone, *A Theory of Capacity and the Insurance of Catastrophe Risks (Part II)*, 41 J. RISK & INS. 339 (1973). Technically, an insurer's need for spread is not the same as its need to avoid catastrophe exposures; a catastrophe exposure results when risks assumed are not sufficiently independent. Practically, of course, both represent a breach of an insurer's stability constraints, a fact reflected in the common industry practice of lumping the two together for statistical purposes.

homogeneous independent risks making up the portfolio increases. Reinsurance can help to satisfy this concern, but its effects also are felt in underwriting strategies. As a consequence, based on its concern for achieving adequate spread, an insurer's underwriting rules may cause it to refuse to commit its resources to insuring some risks, even if as a class such risks appear to be profitable and even if the particular risk is a better than average member of the class.<sup>47</sup>

### 3. *Moral Hazard*

"Moral hazard" is the label applied by insurers to the possibility that the insured's reaction to the presence of insurance will increase the loss potential of the risk. In theory, moral hazard is a problem for an insurer because it represents a deviation from the assumptions of rate classification schemes;<sup>48</sup> the problem of moral hazard should be a problem of risk heterogeneity, potentially subject to treatment by incorporating appropriate rate factors in the classification systems. Practically, however, that is not done nor is it likely to be done. Although at least some moral hazard can be viewed as the product of rational economic behavior subject to standard economic analysis and treatment,<sup>49</sup> the insurance industry has not been willing to try to rate it but instead has steadfastly regarded moral hazard as an ethical and moral failure which should not be insured and which, in any event, is unquantifiable.<sup>50</sup> Consequently, underwriting rules will dictate rejection of a risk if moral hazard is suspected.

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47. For an application of the argument to the availability problems experienced by some restaurants, bars, seasonal dwellings, and other classifications which "would have produced a good profit for an insurer if an adequate number of the large risks were insured, making the law of large numbers operative," see Barrett, *Profitable High Hazard Risks*, National Underwriter (P & C), June 29, 1973, at 31, col. 1. Not uncommonly, bowling alleys, supermarkets, discount department stores and other buildings with large, undivided areas produce the same reactions. See generally R. HOLTOM, UNDERWRITING 378-80 (1973).

48. I. PFEFFER, *supra* note 32, at 62.

49. Most recent work on "moral hazard" has focused on how it may affect the traditional welfare case for public provision of health insurance. See generally Arrow, *supra* note 25; M. PAULY, *supra* note 25. See also Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 7 (1969): "A price can be and is attached to the sale of all insurance that includes the moral hazard cost imposed by the insured on insurance companies. And this price is individualized to the extent that other costs, mainly cost of contracting, allow"; Joseph, *The Measurement of Moral Hazard*, 39 J. RISK & INS. 257 (1972).

50. Adams, *Underwriting in Fire Insurance*, in J. LONG & D. GREGG, *supra* note 34, at 190, 194; I. PFEFFER, *supra* note 32, at 119.

Thus, an insurer's attitude toward a particular risk will be colored by many concerns, only some of which are a function of particular features of the risk. The insurer understands, though the insured and the rejected applicant may not, that "[t]here is no one proper rate, per se, for an individual insured or exposure,"<sup>51</sup> and that, for the same reasons, the "insurability" of a risk cannot be determined solely by its intrinsic characteristics.

#### 4. *Implementing Selectivity: The "Organizational Filter"*

Moreover, the "organizational filter"<sup>52</sup> through which an insurer's concerns about the character of its risk portfolio are translated into specific underwriting decisions also tends to exert a pervasive influence on how property insurance availability problems are framed. Demands for the exercise of underwriting judgment—at best an uncertain "mixture of experience, acumen, and instinct"<sup>53</sup>—are felt at numerous junctures throughout the insurer's distributional apparatus, with consequent opportunities for idiosyncratic and other imperfect judgments to be exercised. In practice, of course, institutional habits and devices operate to trammel some of the discretion of individual underwriters and producers. Thus, the cartel-imposed uniformity of property insurance rates and policy provisions long permitted little room for tailoring rates and forms to the particular contours of particular risks, and habits of thought born of the cartel did not die with it; property insurance underwriters tend to perceive their options to be limited to accepting or rejecting risks,<sup>54</sup> with the burden of developing capacity passing by default to the independent agents and brokers who long have dominated this phase of the insurance industry. Furthermore, both producers and those with direct underwriting responsibility may find their compensation or their continued association with the insurer tied to the experience of the risks they contribute to the insurer's portfolio.<sup>55</sup> Designedly, these contingent commission

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51. G. HARTMAN, *supra* note 32, at 25.

52. The term is used in Gordon, *Short-Period Price Determination*, 38 AM. ECON. REV. 265, 288 (1948). As employed here, it is meant to suggest both "managerial" and "behavioral" influences on organizational decision making within an insurance bureaucracy. See generally Machlup, *Theories of the Firm: Marginalist, Behavioral, Managerial*, 57 AM. ECON. REV. 1 (1967).

53. Kulp, *The Rate Making Process in Property and Casualty Insurance—Goals, Technics and Limits*, 15 LAW & CONTEMP. PROBS. 493, 500 (1950).

54. Thus, Brockmeier speaks of "an historical perspective placing emphasis on account quality rather than price," Brockmeier, *supra* note 40, at 45. The attitude is often explicit in R. HOLTHOM, *supra* note 47.

55. Barrett, *supra* note 47, provides a striking commentary on the way

agreements and similar institutional arrangements<sup>56</sup> ingrain conservative risk selection attitudes at the critical levels of the underwriting process and further accentuate the market-limiting effects of capacity concerns about risks thought to pose the threat of high expected variation from the classification mean. Perhaps most importantly, however, at all levels insurer concerns soon become codified, formally or informally, into decision rules that channel discretion and help to produce a measure of consistency and uniformity in an insurer's underwriting decisions.<sup>57</sup>

Although such institutional constraints may help to discipline the decisions emanating from the various levels of an insurer's acquisition system, they do little to alter the essentially subjective character of the judgments involved. Inevitably there is in the rating and underwriting problem a large element of irreducible uncertainty. Beyond that, however, much in the rating and under-

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considerations of spread may be felt within the underwriting process:

An individual underwriter is not apt to be impressed with the figures [showing profitability for the classification as a whole] . . . because his performance is judged on the small book of business he underwrites and he knows this book could never be large enough for any of these classifications to set in motion the law of large numbers. Consequently, the individual underwriter takes what he considers to be the most prudent action. He shuns such risks, or takes a small portion of the total coverage. He is not impressed that on a national basis only a small percentage of restaurants burn down; he is concerned that the restaurants that do burn down will be the ones that he has accepted.

*Id.* at 31.

56. Goldbeck & Hanlon, *Personal Lines Underwriting: An Alternative Approach*, BEST'S REVIEW (P & L), Nov. 1976, at 26, suggests that agency selection & discipline rather than analysis of applications is more likely to prove fruitful at least for the personal lines. They suggest "profiling the characteristics of business submitted by individual agents." Of course, contingent commission arrangements, writing limits, and restricted binding authority are traditional industry techniques, as are account terminations. For an indication of the tensions thus produced, see White, *Insurance Producers Account Terminations*, 23 CPCU ANNALS 167 (1970); Note, *Independent Insurance Agency Agreements and the Termination of Agency: Antiquated Approach to the Modern Market*, 49 B.U. L. REV. 286 (1969).
57. Compare the discussion of "ineligible tests" in R. HOLTOM, *supra* note 47, at 127-32, with Zelomek, *Business Pricing: The Irrational Uses of Irrational Rules of Thumb*, in PRICES: ISSUES IN THEORY, PRACTICE, AND PUBLIC POLICY 202, 203 (A. Phillips & O. Williamson eds. 1967) (discussing with approval "the so-called rule of thumb, which in a business sense is defined as judgment based on practical experience rather than on scientific knowledge or analysis"); Baumol & Quandt, *Rules of Thumb and Optimally Imperfect Decisions*, 54 AM. ECON. REV. 23 (1964); Winter, *Satisficing, Selection, and the Innovating Remnant*, 85 Q.J. ECON. 237 (1971).

writing practices of insurers can be understood chiefly as attempts to economize on the information costs associated with achieving more refined judgments.<sup>58</sup> The same pressures that have kept the classifications of the rating systems effectively divorced from justifications founded on classified experience also militate for a similar trade-off between greater refinement of underwriting criteria and the costs of securing the information necessary to identify and implement more precise indicators of risk quality. Often the costs of better information and the compulsions of competition make the use of relatively crude rules of thumb the rational course for the insurer to pursue.

### C. Selectivity and Individual Perceptions

Nevertheless, although for the insurer "underwriting . . . depends on averages,"<sup>59</sup> individual perceptions of causal relations usually do not.<sup>60</sup> The disciplines of the underwriting system force upon the insurer recognition that a particular risk sometimes may be an undesirable addition to its risk portfolio for reasons that have nothing to do with the "inherent" hazard of the risk. Thus, in an insurer's calculus of acceptability, even properly rated and better than average risks may be avoided by an underwriter because the low value of the risk produces too small a total premium, because the high value of the risk or the absence of similar risks in the insurer's book of business violates the insurer's concern for spread, or for reasons as mundane as the insurer's inexperience with risks of that sort or its lack of producers in the area in which the risk is located. Moreover, even when the insurer's evaluation of the inherent hazard of the risk is the reason for an adverse underwriting determination, the negative decision may be prompted by the underwriter's belief that the risk lies along the lower margin of the rating classification rather than by a conclusion that the risk is a "bad risk" in any absolute sense. In sum, to the insurer, the attractiveness of a risk is a function both of its inherent hazard

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58. *Id.* See generally Hershleifer, *supra* note 26; *Symposium on the Economics of Information*, 90 Q.J. Econ. 666 (1976).

59. Adams, *supra* note 50, at 194.

60. For a discussion of the factors tending both experts and laymen to rely on a few simple heuristic principles when attempting to make subjective assessments of probabilities, see Tversky & Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 Sci. 1124 (1974). Cf. Dauten & Dauten, *Consumer Perceptions of the Consumer Credit Process*, 10 J. CONSUMER AFF. 62 (1976) (contrasting the perceptions of consumer loan applicants with those of loan officers). No similar study of the insurance underwriting process has been discovered.

and of the particular problems it may pose to the particular insurer; to the individual who finds himself treated as a residual risk, that range of concerns may be less than obvious, and the adverse decision may well appear to be the product of animus or mistake on the part of the underwriter.<sup>61</sup>

To this divergence of perspectives must be added similarly opposed perceptions of the meaning of the insurer's underwriting decision rules. The underwriter is interested in correlations; he is unlikely to ask more of an underwriting rule than that it demonstrate a useful predictive power for the group of risks to which it is applied. In many applications, conceptions of causation are explicitly not a part of the rating, and even the underwriting, inquiry.<sup>62</sup> By contrast, the individual against whom the rule of thumb cuts often shares the common assumption that to rely on correlations is to imply causation, and may well question the fairness of employing an indicator because it is beyond the power of the individual to control, or because it sweeps broadly or is only a rough surrogate for the true variables involved. In that dichotomy resides a tension that is intrinsic to the process we have been describing and that lies close to the heart of the "availability problem" in property insurance. That it is inevitable does not lessen its significance as a regulatory issue.

In the property insurance context this tension at times has acquired a special volatility from the kinds of indicators that underwriters have tended to select. Although other examples are possible,<sup>63</sup> the complexity and sensitivity of the issues that can be generated by the use of these subjectively chosen rules of thumb can be demonstrated by an examination of two prominent kinds of underwriting rules—those designed to factor out risks affected by a "moral hazard" and those designed to distinguish among risks on the basis of their geographic locations.

The concept of moral hazard is well understood and the prescription for it—reject the risk—is clear. Unfortunately, the haziness of the distinctions which must be attempted and the costliness of developing the information needed for more refined indicators often result in the use of underwriting rules of unseemly crudity to iden-

61. See generally PANEL HEARINGS, *supra* note 3, *passim*.

62. A. DEAN, *supra* note 40; Brockmeier, *supra* note 40.

63. For a still-useful collection from the automobile insurance context, see *The Workshop Sessions: Summary Report*, 1967 U. ILL. L.F. 618 (summary of issues raised at conference at University of Illinois); *Hearings on the Insurance Industry Before the Senate Subcomm. on Antitrust and Monopoly of the Comm. on the Judiciary*, 90th Cong., 2d Sess. (1968).

tify situations in which it might be thought to be in the interest of the insured "to sell the property to the insurance company." Indications of potential moral hazard are sought in cheaply observed risk attributes; credit reports, financial records and the observations of producers and field representatives supply much of the information.<sup>64</sup> Although the core concern of the underwriter is the human characteristics of the risk, cheap screening indicators are adopted as surrogates for solid information about the attitudes and values of the prospective insured. Are his facilities obsolete? Is his mercantile establishment located in an area of declining or shifting residential populations? Is he seeking a high insurance-to-value ratio? Is he experiencing financial difficulties? Are there abnormalities in his personal life? The invitations to underwriters to introduce prejudgments and biases and to indulge amateur psychological stereotypes are apparent. Even generalized underwriting texts include occupational, ethnic, racial, geographic, and cultural characterizations certain to give offense if publicly stated.<sup>65</sup>

Related tensions are generated by the use of broad-gauge underwriting decision rules based on the geographic location of the risk. During the 1960's, "red-lining," "blackout maps," and "postal zone underwriting" became familiar entries in the property underwriter's lexicon. Perhaps their prevalence can be explained as another instance of economizing on information costs in the face of a widespread lack of confidence in the answers provided by prevailing rating systems. Often neighborhoods are born, mature, and decline together, but of the three factors which influence fire insurance rates for class-rated properties, only the protection grading in any way reflects the location of a risk, and it does not permit rating distinctions for differences in location within most urban areas. Rather than incur the costs of inspecting habitational risks to determine their individual risk characteristics, underwriters employ the convenient surrogate of location. In the case of mercantile structures, red-lining also might be merely a rational use of rules of thumb, even though schedule rating allows some reflections of building conditions and exposures—presumably important elements of the underwriters' concern—because of limited confidence in the

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64. R. HOLTOM, *supra* note 47, at 214-16.

65. See A. CAMPBELL, *INSURANCE AND CRIME* 121-76 (1902) (providing a lurid list of instances in which the presence of insurance provoked criminality); J. MAGEE, *AN APPROACH TO THE STUDY OF MORAL HAZARD* 13-15 (1933) (indulging a series of racial and ethnic stereotypes); C. RUPPRECHT, *THE MODERN FIRE UNDERWRITER* 23 (1940) (reporting that "[c]ertain types and groups of people and certain races have characteristics detrimental or dangerous to insurance companies and their interests"); P. REED, *FIRE INSURANCE UNDERWRITING* 295 (1940) (reflecting similar views). But see R. HOLTOM, *supra* note 47, chs. 15-16.



schedules and the ways they are applied and awareness of the lag time and likelihood of significant changes between reinspections. Nevertheless, rational as the use of such decision rules might be, they often displayed a distressing tendency to be drawn to correspond with racial residential patterns and could easily be perceived to be an attempt to avoid what one academician delicately phrased "the public moral hazard."<sup>66</sup>

The indicators employed in the search for moral hazard and the geographic distinctions used in property insurance rating and underwriting decisions invite popular dissatisfaction, and it has been forthcoming. Less apparent, perhaps, is that similar complaints would seem applicable in some degree to the use of all such indicators. As we have seen, the price that people pay for property insurance, and whether they get insurance at all, can turn on considerations unrelated to the inherent hazard of the particular risk, and can be determined by the application of decision rules that may be the product of a biased "taste for discrimination," sloppy thinking, or the subjugation of concern for precision to a concern for avoiding the costs necessary to secure better information.<sup>67</sup> The decision rules used to identify moral hazard and those involving geographic distinctions differ from these others, if at all, chiefly in the numbers of risks they affect and in their apparent transparency to critics who would find a racial or other improper motive behind their use.

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66. Long, *The Future and Insurance*, 34 J. RISK & INS. 515, 517 (1967).

67. For access to the burgeoning literature concerning the economics of discrimination, see generally Stiglitz, *Approaches to the Economics of Discrimination*, 63 AM. ECON. REV. 287 (1973) (categorizing economic explanations as those that emphasize "discriminatory preferences" and those that emphasize market imperfections—chiefly informational), and citations collected therein. The first approach is most fully stated in G. BECKER, *THE ECONOMICS OF DISCRIMINATION* (2d ed. 1971); the second has received its most graceful presentations in Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Phelps, *The Statistical Theory of Racism and Sexism*, 62 AM. ECON. REV. 659 (1972); and Arrow, *Models of Job Discrimination*, in *RACIAL DISCRIMINATION IN ECONOMIC LIFE* (A. Pascal ed. 1972). For an indication of the passions that can be stirred when attempts are made to transfer the explanations suggested by economic modeling to a discussion of real world phenomena, compare Williams, *Why the Poor Pay More: An Alternative Explanation*, 54 Soc. Sci. Q. 377 (1973) (emphasizing use of cheaply observed attributes as decision bases as rational attempt to economize on information costs) with Sturdivant, *Rationality and Racism in the Ghetto Marketplace*, 54 Soc. Sci. Q. 380, 383 (1973) (attacking journal for publishing an attempt "to rationalize racial stereotypes as a basis for human behavior").

Thus, risk selectivity, even when predicated on indicators of broad generality, should not be defined too casually as an aberration to be quickly prohibited when it runs afoul of rising public demands for additional coverage and particularized decisions based on the inherent hazards of particular risks. Doubtless, some such demands for restrictions are legitimate, and should be honored, but they must confront the reality that the process, if not necessarily its details, is inevitably a central feature of the insurance technique as practiced by private insurers competing for heterogeneous risks.

The practical questions that this tension poses for public policy are whether and in what manner the underwriting process or its results or both should be constrained by governmental initiatives. Broadly stated, the possible answers are three: (1) government can simply accept the outcomes produced by the normal underwriting process; (2) it can choose not to intervene in the underwriting process, but attempt to assure coverage for some or all of the risks rejected by the standard market; or (3) it can attempt to constrain underwriting discretion in an effort to purify the process or to assure underwriting outcomes.

Where once drift and inertia produced general acquiescence in the first of these alternatives, increasingly during the last decade the property insurance industry and its regulators have been forced to acknowledge the possibility and implications of some combination of the other potential choices. How they have responded in the property insurance context is the subject of the remainder of this article.

### III. THE PROGRAMS: ANTECEDANTS, IMPLEMENTATION, AND ADMINISTRATION<sup>68</sup>

#### A. Underwriting Discretion and the Instinct Toward Voluntarism

For most of the history of property insurance regulation, these questions seldom have been posed squarely to regulatory officials.

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68. Unless otherwise indicated, statements in section III of the text concerning the state programs at various stages of development are based primarily on a collection of the implementing documents for the several programs compiled by the author. Some statements concerning the early programs may be based on a report of a survey conducted by the Central Office of the NAIC in early 1969 *reprinted in* II 1969 NAT'L. A. INS. COMMISSIONERS PROC. 516-35; an unpublished tabulation compiled by the Insurance Company of North America in 1969; FEDERAL INSURANCE ADMINISTRATION, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, REPORTS ON FAIR PLAN OPERATIONS 1971 (January, 1972) [hereinafter cited as REPORTS ON FAIR PLAN OPERATIONS 1971]; a

From an early date most states subjected property insurance rates to statutory requirements that they not be "excessive, inadequate or unfairly discriminatory." However, despite the obvious connections between rate classifications, rate levels, and underwriting decisions, insurance regulators have never used these standards as the basis for inquiries into underwriting practices of individual insurers.<sup>69</sup>

In part, of course, this failure seems simply to have reflected a wise discretion: insurance regulators, like their counterparts in public utility regulation,<sup>70</sup> have displayed a habitual and understandable reluctance to become embroiled in the intricacies of industry rate structures in attempts to impose a regulatory vision of appropriate correspondence between rates and anticipated costs, even where the complications of different underwriting approaches have not been thought to be a part of the problem. Historically, regulatory concern for the solidity effects of "inadequate" rates and for the political consequences of permitting insurer revenues to outstrip costs and expenses by too great a margin usually could be vindicated without looking much beyond aggregate results.<sup>71</sup> Selection of classification bases and related questions of rate design remained almost entirely the province of the industry, usually operating through its rating bureaus. Where issues of rate equity did push their way into the regulatory consciousness, they most often were framed by insurers or producers as complaints about "destructive" price cutting or rebating by their competitors; as a result, the dominant emphasis given the prohibition against unfair discrimination has been felt in efforts to promote the formal equity of conformance to the rate structure. More fundamental questions about the legitimacy of the rate design itself have gone mostly unasked or have been brushed aside as the inevitable special pleading chal-

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series of reports on individual FAIR Plans by the Federal Insurance Administration's Office of Review and Compliance, released in 1973; a "Compendium of Individual State Property Insurance Plans" prepared by the Property Insurance Plans Service Office in 1975; and the periodic "Fair Plans—Reports of Operations" prepared by the Insurance Services Office from data supplied by the individual FAIR Plans, reproduced in the annual *Proceedings* of the National Association of Insurance Commissioners. All are on file in the University of Nebraska College of Law. Of course, the conclusions drawn from these materials are the responsibility of the author.

69. See generally J. HANSON, R. DINEEN, & M. JOHNSON, *supra* note 1, and authorities collected therein.

70. See, e.g., II A. KAHN, *supra* note 18, at 54; J. BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 287-93 (1961).

71. Perhaps the best statement of the traditional view that insurance rating objectives "may be achieved at various levels" and "over time" is provided by G. HARTMAN, *supra* note 32, at 33-34.

lenges to the treatment of particular groups of risks that must be expected in any insurance arrangement where broad averaging is required. They certainly have never been thought to lead regulatory officials to expect an insurer to write all applicants for insurance at the rate prescribed for the classification into which they fall.<sup>72</sup>

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72. For a traditional treatment of the statutory requirement that rates not be "unfairly discriminatory," see C. WILLIAMS, *PRICE DISCRIMINATION IN PROPERTY AND LIABILITY INSURANCE* (1959); Williams, *Unfair Rate Discrimination in Property and Liability Insurance*, in S. Kimball & H. Denenberg, *supra* note 6, at 209.

Professor Kimball's seminal article, "The Purpose of Insurance Regulation," Kimball, *supra* note 1, an exhaustive catalog of the "public policy objectives" that have shaped insurance regulation, employs a somewhat broader perspective, and thus locates among the aims of the regulatory system a notion that rating and underwriting standards should be equitably "related to the characteristics of the individual applicant." *Id.* at 497. From this objective he derives two important generalizations. First, *a priori* classifications present special dangers, since the defining characteristics chosen may have only a partial correspondence with the true causal factors. For example, Negroes have often been "rated up" in life insurance, based on the undeniable fact that mortality experience for *all* Negroes is less favorable than experience for *all* whites. It requires little sophistication to appreciate the danger in using these categories, for such factors as a less favorable public health environment may well bias the statistics. While reliance on the race classification will protect the company, the classification is too crude, for it sweeps within the disfavored class many who should receive more favorable treatment. A desire to eliminate this particular inequity as in conflict with fundamental moral notions about equal treatment of races has led to statutes forbidding the use of race as a classification. A more refined statistical apparatus which isolated and used the true causal factors would probably exclude it too.

*Id.* at 496 (emphasis in original). Second, [o]ther practices may lead to discrimination against groups of policyholders. For example, whole groups may be excluded from coverage. If the company exercises a sound underwriting judgment one cannot regard this conduct as discriminatory, but the company's standard of exclusion may not always be justifiable. Exclusion of applicants from consideration on the ground of race or color is one such standard that is of questionable validity. Moreover, when the companies think that rates are inadequate, as in automobile liability insurance in the 1950's, the resulting strict application of the company's selection criteria will drive large numbers of "clean risks" into the assigned risk plan, where they are surcharged. There are elements of unfair discrimination in this exclusionary practice, and in 1960 there was developing concern with the problem.

*Id.* at 496-97.

In fact, although such concerns are felt throughout the property insurance regulatory system, only sporadically have they been embodied in statutory or regulatory standards applicable to underwriting judgments by commercial property insurers. Thus, the unfair trade

In fact, although long deemed sufficiently affected with a public interest to warrant detailed regulation extending far beyond the

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practice statutes enacted in each state as part of the coordinated NAIC response to the compulsions of the McCarran Act had almost no applicability to the underwriting decisions of property insurers. See generally Model Act Relating to Unfair Methods of Competition and Unfair and Deceptive Acts and Practices in the Business of Insurance, 1947 NAT'L A. INS. COMMISSIONERS PROC. 383; see also I 1959 NAT'L A. INS. COMMISSIONERS PROC. 145. In 1972, a proposed revision of the Model Unfair Trade Practices Act would have "restricted the right of insurers to reject persons as risks solely because of race, color, creed, marital status, sex, national origin, residence, age, lawful occupation, failure to place collateral insurance, or previous refusal by another insurer." The NAIC "decided not to incorporate such provisions because":

- (1) Some of these matters are presently covered in civil rights laws;
- (2) Some of these points are covered by special statutes relating to auto insurance; and
- (3) The broad philosophical implications would appear to make the treatment of this subject more appropriate in a separate bill. The Subcommittee does recommend, however, that the Automobile Insurance Problems Subcommittee appoint a task force to prepare model legislation.

I 1972 NAT'L A. INS. COMMISSIONERS PROC. 490, 491.

A recent compilation of state unfair trade practice provisions may be found in Bailey, Hutchison, & Narber, *The Regulatory Challenge to Life Insurance Classification*, 25 DRAKE L. REV. 779, 782 n.17 (1976). Most state enactments contained a prohibition against unfair discrimination in rates, benefits and "other terms and conditions" of life insurance contracts, and often contained a similar prohibition for accident and health insurance. Only rarely was the prohibition framed broadly enough to reach insurer practices with respect to property insurance risks. See, e.g., ARIZ. REV. STAT. ANN. § 20-448 (West 1956). In any event, the prohibitions were generally thought to mirror the unfair discrimination prohibitions of the property and casualty rating laws, and thus to be inapplicable to underwriting decisions.

Until quite recently, the only legislative deviations from this pattern were scattered statutes attempting to restrict the use of race as a criterion in life insurance underwriting. Despite the demonstrable higher mortality of blacks in general, sensitivity to the dangers of employing such a blunt and morally charged indicator as race as the basis of underwriting decisions produced a few statutory provisions requiring that rejection of black applicants for life insurance be accompanied by a physician's affidavit that the applicant had been refused on grounds that would have produced refusal of a white applicant. See, e.g., CONN. GEN. STAT. ANN. §§ 38-150 to 38-151 (West 1969); MASS. GEN. LAWS ANN. ch. 175, § 122 (West 1972); MINN. STAT. ANN. § 72A.12 (West 1968); N.J. STAT. ANN. § 178:30-12 (West 1974); OHIO REV. CODE ANN. §§ 3911.16 to 3911.18 (Page 1975). The sprinkling of such statutes did not prevent the development of a specialized segment of the life insurance industry specializing in high-cost life insurance coverage for blacks unable to obtain insurance in the standard market. See generally M. STUART, *AN ECONOMIC DETOUR* (1940). Furthermore,

question of rates, the commercial insurer has never been held subject to any general duty to serve all who request insurance. Its rates and its policy forms are regulated, its investments and financial condition are limited by stringent rules, and its marketing sys-

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where statutory restrictions or racial distinctions were not made specifically applicable to underwriting practices, as in the provision now codified as MICH. COMP. LAWS ANN. § 500.2082 (1967), they were not easily extended. See [1951-52] OP. MICH. ATT'Y GEN. No. 1402, at 239 (interpreting statutory prohibition against "any distinction or discrimination between white persons and colored persons . . . as to the premiums or rates charged for policies on the lives of such persons, or in any other manner whatsoever" as not applicable to instructions to producers not to solicit applications from blacks). In the last decade, by both legislative and regulatory action, numerous states have adopted prohibitions against underwriting denials of life insurance or disability insurance or both on the basis of sex or marital status or sexual preference; the mixed pattern is usefully tabulated in Bailey, Hutchison, & Narber, *supra* at 795-801. A sprinkling of state statutes dealing with other narrow problem areas also has appeared. See, e.g., MASS. GEN. LAWS ANN. ch. 175, § 120A (West Supp. 1974) (life insurers prohibited from refusing to insure mentally retarded "for the sole reason of mental retardation"); N.C. GEN. STAT. § 58-195.5 (Supp. 1975) (life insurers prohibited from denying coverage or charging higher rates for individuals with sickle cell or hemoglobin C traits).

Only occasionally have similar restrictions on property-casualty insurers been adopted. In 1940, New York enacted a general prohibition against discriminatory practices based on race, creed, color and national origin, including underwriting practices, by any insurer or producer. N.Y. Laws ch. 796, §§ 1-2 (1940), *as amended*, N.Y. INS. LAW § 40(10) (McKinney 1966). New Jersey more recently adopted a similar measure. N.J. Laws ch. 139, § 1 (1965) (codified as N.J. STAT. ANN. § 17:298-4(7)(c) to 4(7)(e) (West 1970)). Several states have recently adopted measures making refusal to insure an unfair trade practice if based on age (except for life, accident and health insurance), residence, race, color, creed, national origin, ancestry, lawful occupation or marital status. E.g., S.D. COMPILED LAWS ANN. § 58-11-55 (Supp. 1976); N.H. REV. STAT. ANN. § 417:4(8)(e) (Supp. 1976).

These few specific restrictions have not significantly altered the underwriting prerogatives of property insurers. Of course, other, more general legal prohibitions of judgments based on certain criteria might be applicable to the underwriting decision. Thus, state public accommodations laws forbidding discriminations on the basis of race, religion or national origin might reach property insurance underwriting judgments. See, e.g., WASHINGTON INS. DEP'T RULING (November 17, 1958). Moreover, in an appropriate circumstance the state action hurdle might be overcome to permit testing of underwriting judgments against constitutional equal protection standards. Thus, in *Stern v. Massachusetts Indem. & Life Ins. Co.*, 365 F. Supp. 433 (E.D. Pa. 1973), a challenge to life insurance classifications by sex, the court found sufficient state action to allow plaintiff to survive a motion to dismiss; however, the state insurance department was also a defendant in that action, and the decision preceded *Jackson v. Metropolitan Edison Co.*,

tem is the object of licensing requirements and continuing surveillance, but the individual insurer is not considered a public utility, and availability traditionally has not been made an official member of the spectrum of primary regulatory values.<sup>73</sup> Indeed,

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419 U.S. 345 (1974), so that its applicability to underwriting decisions not reviewed by state regulatory officials seems highly questionable. Cf. *Reichardt v. Payne*, 396 F. Supp. 1010 (N.D. Cal. 1975) (action under 42 U.S.C. §§ 1983 and 1985 attacking alleged gender discrimination by insurer and California Commissioner in benefits provided by disability policies dismissed on grounds that nexus between Commissioner and insurer was inadequate to satisfy the "under color of state law" requirement). Even in the absence of state action, federal civil rights statutes may impose some restrictions on insurer underwriting conduct. See, e.g., *Sims v. Order of United Commercial Travelers of America*, 343 F. Supp. 112 (D. Mass. 1972) (42 U.S.C. §§ 1981 and 1982 held applicable to refusal of fraternal insurance company to enter into life insurance contracts with blacks). Cf. *Runyon v. McCrary*, 427 U.S. 160 (1976); *UAW v. State Farm Mut. Auto Ins. Co.*, 350 F. Supp. 522 (N.D. Ill. 1972).

Of course, restrictions on discrimination by employers will indirectly impose standards on the insurance coverages provided to employees as part of a fringe benefit package. For an excellent short summary of the impact of the requirements of the Equal Pay Act of 1963; the Civil Rights Act of 1964; the Age Discrimination in Employment Act of 1967; and a variety of executive orders, administrative rules, and state statutory restrictions on discrimination in employment, see Bailey, Hutchison, & Narber, *supra* at 805 n.82. See also Gerber, *The Economic and Actuarial Aspects of Selection and Classification*, 10 FORUM 1205 (1975).

73. Professor Kimball also identifies among the external demands felt by the insurance industry, "[p]ressures for extension of insurance coverage," but draws his examples from a limited number of public and quasi-public insurance programs, and describes the impacts of such pressures on insurance regulation in language largely subjunctive. Kimball, *supra* note 1, at 512-14. After noting the spread of financial responsibility laws, he concludes:

This produces the assigned risk plan, and compulsion on the company to insure. At this point insurance begins to look like a public utility. The consequences of this change are immense. If it is urgently required that insurance be available to all comers, it is more difficult to implement with the same degree of effectiveness the basic objective of solidity of the enterprise, or even the less crucial but important objective of equity among policyholders. Libertarian objectives are challenged. All must be qualified by the overriding needs of society. If solidity is endangered, public subsidies or public guarantees are not far behind. If subsidies are required, considerations of equity give way to convenience to the tax gatherer. The public policy with which we are dealing leads to serious conflicts of important values.

*Id.* at 513-14.

The general approach for public utilities has been quite different: "A regulated company is required to serve all who ask for, and are willing to pay for, service within the area where it holds itself out

until recently, in the few instances when formal regulatory attention has been directed to questions of which risks an insurer is to write, it almost always has been to *restrict* the risks which insurers would be permitted to accept.<sup>74</sup>

This traditional deference to the idea of untrammelled underwriting discretion has been able to draw its justification from a rich vein of conventional business attitudes and immediate business concerns. To insurer and regulator alike, the "underwriting prerogative" has been viewed as an important protection for the solidity of the insurer and a logical corollary of the absence in insurance regulation of the guaranteed rate of return so prominently featured in public utility regulation. The right to be selective in the assumption and retention of risks has meant the freedom to tailor marketing strategies to a variety of business and social conditions, to choose and enforce one corporate identity rather than another, to correct mistakes, even to withdraw completely from an inhospitable economic or regulatory situation.<sup>75</sup> More than that, however, to insurers who perceive themselves as forced to assume an increasingly defensive posture toward the substitution of governmental interference for managerial discretion on a variety of fronts, the underwriting prerogative has served as an important political symbol, at once an affirmation that the insurer still may command its own destiny and an effective rallying point for resistance to further governmental intrusions.

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to serve." C. PHILLIPS, *THE ECONOMICS OF REGULATION* 418 (1965). Of course, the duty is not absolute. See generally *id.* at 418 n.52; F. WELCH, *CASES & TEXT ON PUBLIC UTILITY REGULATION* chs. 3 & 4 (rev. ed. 1968).

In 1965, just before the onset of the developments considered here, Professor Kimball noted the growing similarities to public utilities: "[I]f companies could not choose their policyholders at will, then insurance would be virtually a public utility. That day may not be far away." Kimball, *Regulation at the Crossroads*, 18 *CPCU ANNALS* 155, 164 (1965).

For an attempt to grapple with similar questions, this from a vantage subsequent to many of the developments discussed in this article, see J. HANSON, R. DINEEN, & M. JOHNSON, *supra* note 1, at 95-96.

74. S. KIMBALL, *INSURANCE AND PUBLIC POLICY* 142-49 (1960). Kimball classifies the underwriting restrictions in terms of limitations intended to assure that companies achieve an adequate spread of risks in order to avoid catastrophes, and limitations designed to maintain high quality in the risks selected.
75. Numerous examples of withdrawals and threatened withdrawals are possible. For an historical sampling, see S. KIMBALL, *INSURANCE AND PUBLIC POLICY* 171, 243, 273, 276, 284 (1960). Doubtless the possibility of retraction or withdrawal is perceived by the industry as one of the advantages of a state-based regulatory system.



Thus, it should not surprise that hardly any direct incursions have been made upon it. Instead, where demands for insurance protection to which the market has not seemed prepared to respond have found recognition in the political arena, the usual approach has been to create a new mechanism, not to impose a general regulatory requirement that commercial insurers provide the protection.

### 1. *Intermediate Mechanisms and the Traditions of Voluntarism*

The distinction may be too facile. The prevailing deference to untrammelled insurer underwriting discretion for most of this century has been linked in an uneasy synergism with traditions of insurance industry voluntarism grounded chiefly in industry fears of governmental displacement.<sup>76</sup> As a result, the variety of coverage-providing institutions that have helped to permit continued avoidance of direct regulatory inroads on the underwriting prerogative seldom have been unequivocally public, and sometimes by the manner in which they have structured and justified participation by commercial insurers have tended to import their own subtle subversions of insurer underwriting discretion. The point is important enough to warrant some detail.

Economic security programs in this country currently are delivered by a complex mix of commercial insurance companies, governmental insurance programs, and such intermediate mechanisms as uninsured pension funds, hospital and medical service plans, and residual market mechanisms. The allocation of functions among these devices has followed no articulated theory; efforts to classify the programs have trailed in the wake of changing social perceptions of the nature of risks and changing fashions in institutional arrangements. The structural similarities of public and private bureaucracies and the expansion of governmental activities have further operated to obscure the line of demarcation. Workmen's compensation insurance, the first of the "social" insurances in this country, is written primarily by commercial insurers despite the presence of monopolistic governmental funds in some states and competing governmental funds in others. The most recent of the social insurances, medicare, employs private organizations to perform the bulk of the day-to-day operations of the program. The

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76. For an incisive and articulate discussion of the "cluster of political, social, and economic principles" upon which the American variant of the ideology of voluntarism has drawn and its influence on the development of professional and public attitudes concerning social insurance theory and policy, see R. LUBOVE, *THE STRUGGLE FOR SOCIAL SECURITY 1900-1935* ch. 1 (1968). See also O. HANDLIN & M. HANDLIN, *THE DIMENSIONS OF LIBERTY* ch. 5 (1961).

result is a mixed system in which it has become increasingly risky to identify the thrust of a program by the institutional character of its administrator. As Harlan Cleveland has soundly noted: "The line between what is public and what is private can no longer be drawn between government and nongovernment organizations. The line between what is public and what is private must be drawn within each organization, between its publicness and its privateness."<sup>77</sup>

With the important distinctions between public and private thus blurred, the explanations and slogans that accompany the participation of insurers in a particular program can profoundly influence what they are asked to do and how programs are allowed to develop. So it has been with the residual market mechanism. Traditionally, much of the thinking and rhetoric of insurers and regulators concerning availability problems has been framed in terms of pressures on the commercial insurance industry to assume risks that are "incident to the business." Yet, as we have seen, these sporadic pressures have not been translated into special legal obligations to "take the good with the bad" in the manner of the public utility industries. Instead, the prevailing theme has echoed the warning of Adolf Berle, addressed to all corporate entities: "[T]he corporation, having won its place in the economic system must fill it."<sup>78</sup> Professor Kimball especially has given currency to the idea that availability problems represent "pressure from society at large to compel the insurance institution to do the job for which it exists."<sup>79</sup> He concludes:

One important corollary to the key role played by insurance is this: in order for insurance to do its job, in order to provide both security and a feeling of security for substantially all members of the social organism, insurance must be comprehensive in its coverage. I.e., substantially all persons in the community must somehow be brought within the protective scheme that constitutes insurance. This is not merely desirable; it is imperative. In primitive society the fiction of adoption was born to make sure that everyone would get inside one of the kin groups which would provide him mutual aid. If commercial insurance does not provide a modern equivalent to the fiction of adoption, it does not do its job, and something else will replace it.<sup>80</sup>

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77. Cleveland, *The Blurred Line Between "Public" & "Private,"* in *ETHICS & BIGNESS: SCIENTIFIC, ACADEMIC, RELIGIOUS, POLITICAL AND MILITARY XIII*, xxvi (H. Cleveland & H. Lasswell eds. 1962).

78. A. BERLE, *POWER WITHOUT PROPERTY* 102 (1959). See also W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970* (1969).

79. Kimball, *supra* note 1, at 512.

80. Kimball, *Insurance and the Evolution of Public Policy*, 15 CPCU AN-

This sense of an inchoate public consensus giving enlarged content to a functional definition of the role of the commercial insurer and enforcing that definition by the threat of displacement by governmental or intermediate programs has been especially strong in the property-liability industry. The development of the early residual market mechanisms for automobile and workmen's compensation risks are habitually and accurately described as prompted by the industry's fear that state funds would provide the coverage if commercial insurance did not.<sup>81</sup> Basic to the motivation is con-

NALS 128, 131 (1962).

It is quite possible for a whole institution to commit suicide if it does not accommodate itself to the winds of change, and in the present context, that means if it does not adjust itself to perform the full task now assigned to it by the social organism. If private insurance is to survive as a private institution, it must recognize the central importance of the function it performs in society, must take pride in it, and must perform it ungrudgingly and fully. If it does not, it certainly will be replaced by institutions, largely governmental, that are more responsive to the needs and demands that exist below the surface of society, and it will have failed.

*Id.* at 143.

Of course, Professor Kimball did not originate the message. See, e.g., Yount, *Insurance Problems of Tomorrow—Challenges to Survival*, 14 CPCU ANNALS 225 (1960); Cline, *Maintaining Property Insurance Markets*, 18 CPCU ANNALS 29 (1965).

81. That is, when the decision is not baldly attributed to the public-spirit-  
edness of the commercial insurers. Compare St. Clair, *Occupational Disability—Privately Insured*, in OCCUPATIONAL DISABILITY AND PUBLIC POLICY 91, 93 (E. Cheit & M. Gordon eds. 1963) ("[t]he insurance industry owes employees and the public the duty of maintaining an insurance market which will provide every employee seeking workmens compensation coverage an opportunity to obtain it.") with C. KULP, CASUALTY INSURANCE 151, 155 (3d ed. 1956) (emphasizing the threat of state funds and the willingness of insurers to carry workmens compensation as an accommodation because of the great number of opportunities it affords for selling other coverages). For an excellent running account of the ebb and flow of pressures and the difficulties in distinguishing between "public" and "private" responsibilities, see National Underwriter (F & C), Jan. 14, 1937, at 29, col. 1, and Jan. 21, 1937, at 31, col. 1 (Illinois insurers resisting a proposed voluntary occupational disease assigned risk plan in the face of threats of a state fund, because of inclusion of accumulated hazards without an examination, on the grounds that protection against such hazards "is a public responsibility and not one of the casualty companies, and . . . it is nothing more or less than an attempt to provide social security at the expense of the carriers").

The struggle over automobile financial responsibility laws and assigned risk plans is well known. For a representative account, see C. KULP, *supra* at 185. For an arresting colloquy on the difficulty of labeling why insurers participate in automobile liability insurance assigned risk plans, see the exchange between Senator Tydings and John Nangle of the National Association of Independent Insurers in *Hear-*

cern that once established a governmental program would not limit its operation to residual risks unwanted by commercial insurers;<sup>82</sup> an insurance operation, after all, requires comparatively little in the way of capital investment, and insurance is "a line of work in which government also has a certain talent and expertise. . . . Government indeed comes in where private business drops out, but once in government may go further. No one, and certainly no sovereign, should be expected to conceive his mission as nothing more than picking up after someone else."<sup>83</sup> The fact that residual market mechanisms were not until recently developed to meet availability problems with other coverages does not truncate the validity of this characterization. The specter of displacement, as with any threat, is effective only to the extent that it is credible, and in the first two-thirds of this century only in workmen's compensation insurance and automobile liability insurance among those normally written by commercial insurers was insurance coverage made mandatory, or practically so, by legislation.

Of course, this is not the only possible explanation of the process. From another perspective,<sup>84</sup> less dominated by conceptions of insurance as an instrument of social policy, the role played by the insurance industry in the residual market mechanisms might appear quite different. In this view, a government confronted with strong public demands that it assume functions not performed by other institutions within society, yet not greatly expand its own bureaucracy, has seen as both necessary and desirable that it farm out to insurers a large portion of what is essentially a public concern. At some point, government accepts responsibility for providing mechanisms for spreading risks where other mechanisms do not develop,

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*ings before the Subcomm. on Business and Commerce of the Senate Comm. on the District of Columbia, 90th Cong., 2d Sess. 233-341 (1968).*

For an excellent general treatment of the automobile assigned risk plans, see D. REINMUTH & G. STONE, *A STUDY OF ASSIGNED RISK PLANS* (1970), and DIVISION OF INDUSTRY ANALYSIS, BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, *INSURANCE ACCESSIBILITY FOR THE HARD-TO-PLACE DRIVER* (1970), both part of the Department of Transportation's Automobile Insurance and Compensation Study.

82. Stewart, *A New Responsiveness in Insurance and Its Regulation*, *BEST'S REVIEW* (P & L), Mar. 1970, at 32.

83. *Id.*

84. For a useful statement of this perspective, and a discussion of its implications, see M. WEIDENBAUM, *THE MODERN PUBLIC SECTOR: NEW WAYS OF DOING THE GOVERNMENT'S BUSINESS* (1969), and citations collected therein. See also A. SHONFIELD, *MODERN CAPITALISM: THE CHANGING BALANCE OF PUBLIC AND PRIVATE POWER* (1965); E. GINSBERG, D. HESTAND, & B. REUBENS, *THE PLURALISTIC ECONOMY* (1965); CLEVELAND, *supra* note 77.

even if it chooses for reasons of ideology or efficiency to place administration of the mechanisms in the hands of private organizations. In medicare, a program with frankly public objectives, insurers apparently found highly attractive their role as "fiscal intermediaries" with administrative responsibilities but no risk-bearing function.<sup>85</sup>

In fact, this latter characterization has rarely exerted much influence on the development of residual market mechanisms. Traditions of voluntarism established in the formative years of the assigned risk plans served well enough for nearly three decades, and when attention shifted in the mid-1960's to availability problems of property insurance markets other important conditions combined to make the industry's "voluntary" assumption of responsibility for managing the availability crisis in property insurance seem a desirable and almost inevitable alternative to political interventions and governmental insurance programs.

## 2. Riots, Responsibility and the Role of Industry

The current era of concern with property insurance availability problems can be dated from the development of the homeowners policy in the mid-1950's. The introduction of package policies which provided coverage against fire and allied perils, burglary, theft and personal liability in exchange for a single indivisible premium began to siphon off the better residential risks; those risks that could not qualify for a homeowners policy and the package discount which made it attractive gradually formed a residual class for which available insurance was limited to the separately written coverages. This transfer of the better risks to homeowners' policies left the traditional lines with a built-in selection of low-value dwellings,<sup>86</sup> urban core properties, and other less desirable risks. The results, hardly surprising in an enterprise in which risk selectivity is a crucial element of price competition, included a general tightening

85. See, e.g., H. SOMERS & A. SOMERS, *MEDICARE AND THE HOSPITALS* 32-34, 268 (1967); R. STEVENS & R. STEVENS, *WELFARE MEDICINE IN AMERICA* 48-51 (1974). The actual allocation of functions between the impressive federal administrative structure developed to supervise the programs and the fiscal intermediaries apparently was a matter of no little conflict. See generally Hess, *Medicare and Private Insurance—The Challenge of a New Equilibrium*, 1966 *INS. L.J.* 653. A major difference between Medicare and other governmental programs which have employed private insurance carriers with no assumption of risk on the part of the carriers, such as the World War II War Damage Corporation, is that in the case of Medicare the coverage already was being offered by commercial insurers.

86. Dunham, *The Challenge of the Low Value Dwelling*, 18 *CPCU ANNALS* 209 (1965). See also Chatfield, *Dwelling Fire and Extended Coverage Rates*, 10 *CPCU ANNALS* 118 (1958).

of company underwriting guidelines as the transfer of less hazardous risks to the preferred package policies revealed the wide range of risks which might be encompassed within a single rating classification.<sup>87</sup> With the cream skimmed first by the package policies, and again by underwriters grown wary of risks whose position in the lower reaches of the spectrum of desirability once had been obscured by the general class results, problems of property insurance availability began to command regulatory attention. By 1966, a subcommittee of the National Association of Insurance Commissioners (NAIC) was forced to acknowledge that over half the states were experiencing restricted markets for dwelling fire and extended coverage insurance in urban areas, rural areas, or both.<sup>88</sup> Particularly the subjects of concern were low value dwellings and those located in the blighted areas of major cities.

Initial regulatory responses were facilitative. Some states approved substandard rating plans which allowed insurers to apply surcharges for specific hazardous conditions discovered on a class-rated property.<sup>89</sup> The plans did allow a greater measure of rate flexibility for properties subject to class rates, but a physical inspection of the property to identify specific hazardous conditions was required before surcharges could be employed, and the prospect of an increased premium proved insufficient to induce many companies or agents to incur the costs of inspection and individual underwrit-

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87. See generally G. HARTMAN, *supra* note 32, at 97-111.

88. II 1966 NAT'L A. INS. COMMISSIONERS PROC. 522. The report of the NAIC subcommittee studying the problems presaged later developments; mandatory assigned risk procedures applicable to property risks seemed a credible threat, and the subcommittee offered a program of "cooperation" and "responsibility":

(1) The Responsibility of Owners—for maintaining properties in insurable condition.

(2) The Responsibility of Agents—for being willing to put in extra time and effort necessary to comply with companies' underwriting requirements in the way of on-site or sidewalk inspections.

(3) The Responsibility of Companies—for relaxing underwriting requirements so that any well-owned property maintained in insurable physical condition will find a market regardless of location or value.

(4) The Responsibility of Governmental Authorities—for enforcing building codes, demolition of condemned properties, etc.

(5) The Responsibility of Bureaus—for developing rating plans and schedules which will let the insurers write this business on a no worse than break-even basis without making other classes subsidize it.

(6) The Responsibility of Insurance Commissioners—for using their influence to implement 1, 2, 3, 4 and 5.

*Id.* at 520-21.

89. See generally PANEL REPORT, *supra* note 3, at 56-79.

ing in order to made use of the plans. Any inspection was likely to result in quotation of a premium higher than that produced by the application of manual rates, and there was no guarantee that the prospective insured actually would purchase the insurance if it were offered. He might find his way to another company whose different underwriting standards would permit it to take a chance on the risk at class rates without an inspection, or he might simply forego insurance coverage at the premium quoted. Prospective insureds, for their part, often proved reluctant to seek an inspection and invite attachment of a surcharged rate when there was no assurance that the coverage would be written. Excess rate (ER) plans, which permitted insurers to write property insurance on substandard risks at a rate in excess of filed rate levels if the applicant gave his written consent, were approved in about half the states. These plans permitted even greater rate flexibility than the substandard rating plans because they were applicable to commercial and mercantile properties as well as class-rated property, and because the use of increased rates was not restricted by a fixed schedule of conditions or charges.<sup>90</sup> Nonetheless, these plans, too, received only limited use, mostly by a few small companies specializing in substandard business. When they were employed they often provoked outrage for rates not infrequently ranged as high as 600 per cent of manual rates and usually averaged between 300 per cent and 400 per cent of standard rates.<sup>91</sup>

The failure of increased rate flexibility to alleviate market problems for dwellings prompted regulators to turn from the facilitative to the suasive.<sup>92</sup> The underwriting prerogatives of property insurers remained untrammelled by officially imposed constraints, but in numerous speeches, "bulletins," and "directives," often including amorphous warnings of possible governmental intervention, insurers

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90. *Id.* Such plans were permissible under statutory provisions recognizing that rates in excess of those provided by a filing otherwise applicable might be required to provide coverage on risks having conditions or hazards not contemplated by filed tariffs. See, e.g., MICH. COMP. LAWS ANN. § 500.2614 (1967). Evidence of failure to obtain coverage from licensed companies at filed rates usually was a prerequisite to "consent" rates. The plans were promoted as solutions that would permit recognition of block congestion, inadequate protection, and riot, flood and earthquake hazards.

91. National Underwriter (F & C), May 24, 1968, at 52, col. 1; FIRE INSURANCE IN CONGESTED AREAS I, *supra* note 38, at 15-18.

92. The conclusions stated in the following three paragraphs of the text are based on inferences drawn from a survey of weekly editions of the National Underwriter (F & C) for the years 1960-1969, and Weekly Underwriter, Insurance Department Service, for the years 1963-1969.

were urged to act responsibly in the exercise of their underwriting judgment.<sup>93</sup> For the most part, these were not blanket exhortations; tight markets generally were attributed to the practice of predicating underwriting decisions concerning class-rated property on such indices as the value of the dwelling, its geographical location, or the agency through which it was initially written, rather than upon consideration of the merits of individual risks, and it was upon this practice that efforts to evoke social responsibility focused.<sup>94</sup>

However, the underwriting prerogative appears in several guises. The decision not to insure a risk might come as an initial refusal to offer coverage to an applicant for insurance, as a refusal to renew coverage at the conclusion of the policy term, or as a cancellation of a policy in mid-term. All three facets were involved in the pull-back of insurers from urban dwelling risks, but not all elicited the same deference from regulatory officials. During this period, the prerogative of an insurer to refuse to write a risk after comparing the characteristics of that risk with its own underwriting standards

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93. Moral suasion in this situation offered most of the attractions and was subject to most of the limitations that typically attend this style of governmental coercion. See generally Lewis, *The Economics of Admonition*, 49 AM. ECON. REV. 384 (1959) (listing aversion to direct coercion, doubts about the capacity of governmental institutions, and the desire to appear to be responsive while delaying difficult decisions as the primary motivations for what he labels "creeping admonitionism"); T. Lowi, *supra* note 19, at 85 (emphasizing the prevalence of the pretension that "the unsentimental business of coercion need not be involved"). Romans, *Moral Suasion as an Instrument of Public Policy*, 56 AM. ECON. REV. 1220, 1221-23 (1966), identifies two necessary conditions for effective efforts at moral suasion: strong public support for the policy sought, and a small and easily identified population to be persuaded. He also catalogues the chief objections to the use of moral suasion by government:

Moral suasion is inequitable in that it rewards non-compliance; it constitutes extralegal coercion by government without judicial review; it is in violation of the "rule of law"; where promises, explicit or implicit are involved, it entails the danger of an overly familiar relationship between regulator and regulatee; its ad hoc character adds an additional and unnecessary element of uncertainty to business decisions; and it may frequently be used in lieu of (i.e., as an excuse for not implementing) more effective legislation.

*Id.* at 1221. But see M. EDELMANN, *THE SYMBOLIC USES OF POLITICS* 134-38 (1964) (attempting to explain the attractions and functions of the hortatory style).

94. See, e.g., National Underwriter (F & C), Feb. 26, 1965, at 1, col. 1 (New Jersey Commissioner reporting an "increasing number of complaints which intimate an apparently capricious underwriting procedure by some insurers," and urging the use of "reasonable rules" rather than "willy-nilly whims").



seems never to have been seriously challenged; on the other hand, numerous regulators responded to complaints with requests that insurers refrain from mass cancellations not based on the merits of each risk.<sup>95</sup>

The cases stated seemed to represent opposite ends of a continuum of possible underwriting decisions. The continuum ran along two axes. Cancellations of insurance protection were considered less defensible than refusals to renew a policy, and both engendered more opposition than did an initial refusal to insure. Underwriting decisions in any form were less subject to public and, thus, regulatory criticism if made after consideration of the features of each risk than if founded upon presumptions, rules of thumb, and broad averages. In the exhortations which emanated from insurance departments in the early 1960's, both dimensions were clearly visible. During this period, automobile insurers were experiencing sharp "voluntary" and legislative restrictions on their right to cancel or refuse to renew a policy of automobile liability coverage.<sup>96</sup>

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95. The following "Notice to All Companies Concerned," from the Colorado Commissioner, Dec. 10, 1965, is not atypical in either tone or content:

Along with other state insurance departments, this Department is greatly concerned about the many cancellations prior to declared expiration date of policies by some insurers. We are not concerned with the occasional justifiable individual cancellation of a risk which has experienced an unfavorable change in conditions. Our major concern is the "mass cancellations" of risks.

These so-called "mass cancellations" result from various causes, but we are mainly aware of situations involving the cancellation of an agency with the resulting cancellation of his book of insurance; the withdrawal of a company from a geographical area of the state or a type of policy; and similar mass cancellations.

Cancellation rights should be used by companies with discretion. If a company accepts a risk, and such risk does not develop definitely adverse loss experience in and of itself, the insured should not be penalized due to factors over which he has no control, and which did not enter into the underwriting of his particular risk.

If changes occur which make it desirable for a company to discontinue the underwriting of certain lines, or in certain areas, or through certain agencies, etc., it is the company's responsibility to see that the replacement of coverage is done without penalty to the insured.

96. A useful summary may be found in Zellers, *Regulation of Cancellations and Nonrenewals*, 26 CPCU ANNALS 45 (1973). The rationale for limited incursions into the underwriting prerogative to restrict cancellations and nonrenewals received its fullest statement in STATE OF NEW YORK INS. DEPT., *THE PUBLIC INTEREST NOW IN PROPERTY & LIABILITY INSURANCE REGULATION* (1969):

It is entirely appropriate for the legislature to make a value judgment among the various grounds for cancellation.

For property insurers, however, the primary emphasis of regulatory pressures was upon persuading insurers to base their adverse underwriting decisions, no matter what the form, on consideration of the merits of the individual risk. For the class-rated urban dwellings, this usually meant an inspection.

It was in the context of these pressures that the urban areas plans evolved.<sup>97</sup> In Boston in 1960, in Pennsylvania in 1965, in Detroit

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It is also entirely appropriate for that value judgment to be limited to cancellation, and not to extend to other management activities involving underwriting judgment. The mid-term cancellation of an existing insurance policy involves more than the mere absence of insurance protection. It involves interruption of protection that the policyholder was told he had and—since much of the value of insurance protection derives from the policyholder's ability to plan on the basis of it and to draw from it peace of mind—unjustifiable cancellations undercut some of the most essential benefits of the entire insurance process. Finally, since (i) the essence of insurance is transference of risk from the policyholder to the insurer, (ii) cancellation of a policy by the other party usually works more of a hardship on the policyholder than on the insurance company, and (iii) the parties are so unequal in bargaining power, it is appropriate for the law to restrict the insurer's privilege of cancelling without commensurately restricting the policyholder's privilege of cancelling.

*Id.* at 49.

The possibility of a trend toward judicial restriction of the right of cancellation to "reasonable" motives has been raised by the author of Note, *Insurance—The Exercise of a Cancellation Clause as a Breach of Contract*, 37 U. Mo. KAN. CITY L. REV. 154 (1969). In *L'Orange v. Medical Protective Co.*, 394 F.2d 57 (6th Cir. 1968), the court held that a petition alleging that an insurance policy had been cancelled for the purpose of discouraging a dentist from testifying in liability suits against other dentists stated a good cause of action. The result marks a break from earlier decisions, which permit cancellation regardless of motive. See, e.g., *Camp v. Aetna Ins. Co.*, 170 Ga. 46, 152 S.E. 41 (1930) (upholding the right of Aetna to cancel the fire insurance policy of a judge who made certain distasteful remarks about insurance companies in his charge to a grand jury).

See also I 1971 NAT'L A. INS. COMMISSIONERS PROC. 549 (model statute regulating cancellations of automobile insurance); NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, CANCELLATION—SUMMARY OF STATE LAWS AND REGULATIONS RELATING THERETO (Looseleaf, undated). WISC. STAT. ANN. § 631.36 (West Spec. Pamph. 1976), explained in the 1969 Prefatory Committee Comment to chapter 631: "All too often, cancellation has been exercised with no better reason than timidity in the underwriter who has acted on the basis of guess, hunch, and inadequate information. As a result, the public has recently demanded and secured protection against certain kinds of cancellation."

97. The various urban areas plans, and their limitations, are ably summarized in PANEL REPORT, *supra* note 3, at 56-79. See also FIRE INSURANCE IN CONGESTED AREAS I, *supra* note 38, and NEW YORK INSURANCE

and Cleveland in 1966, and in New York and Buffalo and a few other cities in 1967, widespread publicity given the shortage of dwelling insurance in urban areas and the apparent imminence of an attempted legislative solution prompted insurers, usually working through their major trade associations, to institute "voluntary" urban areas plans to deal with the problem. In each instance, participating insurers acknowledged a "responsibility" to distinguish between good and bad risks if the burdens of so doing could be rationalized. An individual insurer confronted with an application for insurance of property in a blighted area was free to practice the prerogatives of social responsibility only to the extent that it was exempt from the compulsions of competition,<sup>98</sup> but companies unable to respond individually to calls for uneconomic but "socially responsible" inspections could together provide the necessary inspections without damaging the competitive positions of any of the participants. The plans made inspection of class-rated properties, which had been urged as the responsibility of individual insurers and agents, the duty of the fire rating organization already established to inspect and rate mercantile and commercial property subject to schedule rating. The costs of inspection were included in the general operating costs of the rating organization and shared by sponsoring companies in proportion to their total premiums written in the state.

The plans involved no restrictions on the right of a company to cancel a risk or to refuse to renew coverage at the end of a policy term. They did, however, include "a commitment by insurers to insure all properties that meet reasonable underwriting standards,"<sup>99</sup> and most plans provided for periodic reports to permit the rating organization and the state insurance department to monitor the underwriting decisions made by each company on the inspected risks submitted to it. Most plans did not try to define a "good risk" or to state what underwriting standards would be deemed "reasonable"; insurability was left to the underwriting discretion of the individual companies, subject only to whatever pressures the rating organization or the regulatory authorities might exert.

Thus, the urban areas plans defined the problem of unavailability of dwelling insurance in central city areas as one of insurers engaging in presumptions of undesirability without actual knowledge of the characteristics of the individual risk, spread the incidence

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DEPARTMENT, FIRE INSURANCE IN CONGESTED AREAS (A Second Report to Governor Rockefeller, Dec. 29, 1967) [hereinafter cited as FIRE INSURANCE IN CONGESTED AREAS II].

98. See generally Lewis, *supra* note 93, at 390.

99. FIRE INSURANCE IN CONGESTED AREAS I, *supra* note 38, at 24.

of the cost of making inspections from those insurers receiving applications to most fire insurance companies within the state, and secured a formally stated but largely undefined commitment by individual insurers to act responsibly to provide coverage for all "insurable" dwelling property. The riots which struck the cities in 1967 and 1968 and which provided the impetus for transforming the urban areas plans into "Fair Access to Insurance Requirements" (FAIR) plans caused no significant alteration in either the definition of the problem or the emphasis on voluntary assumption of responsibility by insurers as the key to its solution.<sup>100</sup> In fact, attempted withdrawals of some insurers from central city areas following the riots accentuated the definition of the problem as one of underwriting on the basis of geographical area. Calls by state officials for moratoria on area cancellations pending the development of programs to deal with the urban insurance crisis, in stressing the special responsibility of insurers as the most mutual of all corporate citizens, continued to rely on exhortations rather than direct regulatory controls. Perhaps most important of all in setting the dominant tone, attempts by leaders of the insurance industry to secure federal assistance to cope with the riot hazard led them to confess supposed prior delinquencies<sup>101</sup> and pledge new social responsibility to help meet the problems.<sup>102</sup>

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100. See comment by Governor Hughes concerning the Panel recommendations: "You see the sense of it is to impute higher responsibility to the insurance company not to be capricious or bigoted or not forget, in other words, a measure of social responsibility compatible with business safety." PANEL HEARINGS, *supra* note 3, at 304; PANEL REPORT, *supra* note 3, *passim*.

101. Gradually but perceptibly, as attention focused on preventing mass withdrawals by insurers and insurers made their case for relief from the riot hazard, underwriting by area was changed from a lack of positive virtue to the abuse of red-lining. See, e.g., National Underwriter (F & C), Nov. 17, 1967, at 4, col. 1 (speech by insurance company executive):

In the past the problems of inadequate rates, of competition, the shackles of past practice, and perhaps our own inertia may have led us too often into practices for which there is no justification. Class underwriting, or "slot underwriting," as it is sometimes called, and underwriting judgment based merely on averages, rather than consideration of the individual, are the seeds of many of our difficulties.

See also National Underwriter (F & C), July 19, 1968, at 1, col. 1 (red-lining discontinued "because we were being prejudiced").

102. The only significant analysis of the character of the social responsibility upon which the urban areas and FAIR programs relied is provided in McGuire, *The Changing Nature of Business Responsibilities*, 36 J. Risk & Ins. 55, 61 (1969). He distinguishes the conduct expected of property insurers in participating in the state programs ("enlightened") from the 1969 pledge of the life insurance industry to make

Means of protecting the solvency of insurers in the face of new and greater riots dominated the rhetoric. Protection against riot and civil commotion losses had been available from commercial insurers as a part of the extended coverage (EC) endorsement to the standard fire policy for a quarter century preceding the civil disorders of the 1960's; riot coverage, however, had proved a relatively inconsequential feature of the EC package of coverage and produced only a negligible portion of the total premium. The most important aspect of the endorsement was the protection it provided against the windstorm hazard. In its early years the endorsement was popular only in the Midwest where tornadoes presented a constant threat. In the 1940's a series of major storms and hurricanes produced severe wind damage in other sections of the country, and thereafter the EC endorsement became almost an integral part of the fire insurance contract, sold with the basic fire policy as a matter of course. During this period of the endorsement's maturation, the nation enjoyed the longest respite from major civil disorders in its history.<sup>103</sup> Consequently, when riots of the magnitude of Newark and Detroit made their appearance, the insurance industry discovered that the indivisible EC premium contained little provision for riot losses, and that there was little experience upon which to predicate adjustments to account for the riot hazard.

The problem from the point of view of the insurance industry was not so much that it could not absorb its liability under the fire policy and its EC endorsement; the Newark and Detroit disturbances did not produce unbearable dollar losses.<sup>104</sup> What the

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one billion dollars in investments in urban core areas ("responsible"). Apparently the salient difference is that property insurers were feeling the effects of government pressures and were confronted, at least in their eyes, by the spectre of replacement by governmental agencies.

The post-riot motivations of the life insurance industry's investment program in urban neighborhoods have been exhaustively considered in K. ORREN, *CORPORATE POWER AND SOCIAL CHANGE* (1974). See also Mundheim, *A Comment on the Social Responsibilities of Life Insurance Companies as Investors*, 61 VA. L. REV. 1247 (1976). For a useful study of the pressures that prompted post-riot corporate programs in center cities, see J. COHN, *THE CONSCIENCE OF THE CORPORATION*, 1967-1970 (1971).

103. A. WASKOW, *FROM RACE RIOT TO SIT-IN* 220 (1966). No important riots broke the domestic peace during the interval between the Harlem, Detroit, and Los Angeles riots of 1943 and the re-emergence of violence in Harlem, Rochester, and several New Jersey cities in the summer of 1964. Furthermore, the riots of the mid-1960's had a "property, not people" character that distinguished them from earlier outbreaks. Hubbard, *Five Long Hot Summers and How They Grew*, PUB. INTEREST, No. 12, Summer 1968, at 3, 22.

104. See PANEL HEARINGS, *supra* note 3, at 185-194 (early Newark and Detroit insured riot loss statistics); the Panel estimated total insured riot losses in 1967 at less than \$75,000,000. PANEL REPORT, *supra* note 3,

riots did produce was a loss of faith in the efficacy of past experience as a guide to future losses. The law of large numbers is useful only to the extent that the events causing the loss are statistically independent; to insurance company executives and underwriters the civil disorder hazard seemed subject to numerous stimulating influences likely to produce serious problems of aggregation of exposure for individual insurers. Organized leadership of rioters would reduce the residual independence of loss-producing events. Reports of apparent selectivity in burning and looting,<sup>105</sup> stories of express recognition by participants in the disorders of the insurance ramifications of their conduct,<sup>106</sup> and the publicity given governmental decisions to "place life above property"<sup>107</sup> all worked to exacerbate these fears. When initial conspiracy theories began to give way under closer examination of the incidents, they were replaced by recognition that the sparks of riot could be disseminated as effectively by communications media as by the wind. Some perceived the long-term development of a "public moral hazard" which made continued operation of the commercial insurance enterprise a highly speculative venture.<sup>108</sup> Others expressed fears that future riots would not be confined to the center city and might strike areas with higher property values and a greater incidence of insurance protection.<sup>109</sup> Indeed, the civil disturbances which followed the assassination of Dr. King were far less concentrated in their impact and affected far wider areas in each city than had most of the 1967 incidents. Hit-and-run fire bombings of Chicago and New York department stores heightened the apprehension that the disorders were spreading from core city areas to the classes of property which insurers had always con-

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at 4. Insured losses in civil disturbances following the assassination of Dr. King were estimated to approach \$67,000,000. National Underwriter (F & C), May 24, 1968, at 1, col. 2.

105. See, e.g., Fogelson, *White on Black: A Critique of the McCone Commission Report on the Los Angeles Riots*, 82 POL. SCI. Q. 337, 353 (1967) ("[T]he Los Angeles Rioters were so highly selective in their violence that, with few exceptions, they looted and burned only white-owned stores which charged outrageous prices, sold inferior goods, and applied extortionate credit arrangements").
106. See, e.g., TIME, June 28, 1968, at 28, col. 2.
107. See, e.g., Wall St. J., April 11, 1968, at 1, col. 1.
108. Long, *The Future and Insurance*, 34 J. RISK & INS. 515, 517 (1967). See also J. LONG, ETHICS, MORALITY, AND INSURANCE 40-45 (1971); National Underwriter (F & C), Nov. 24, 1967, at 42, col. 1.
109. E.g., 1968 House Hearings, *supra* note 9, at 1095-96 (statement by president of American Insurance Association); National Underwriter (F & C), March 28, 1968, at 1, col. 1 (emphasizing the changing character of riot losses); J. Com., Dec. 2, 1968, at 9, col. 1 (speculating on possibility of sorties into more expensive neighborhoods).

sidered prime risks. Confronted with the spectre of such metastasis, insurers began to defend themselves by another round of tightening underwriting standards, making marginal risks of many properties which previously had experienced no difficulty in obtaining the basic property insurance coverages.

The difficulties were not restricted to class-rated properties; the riots struck hardest at mercantile and commercial risks.<sup>110</sup> The Panel, however, located the source of the problem in the companies' practice of declining the application of an inner city homeowner or businessman "on the basis of the neighborhood where his property is located."<sup>111</sup>

The same reasons adequate insurance is unavailable for dwellings explain why it is unavailable for mercantile and commercial property—there is a failure to distinguish between good and bad risks in an area regarded as "blighted." The problem, always chronic, has now become acute, as insurance companies have increasingly become reluctant to provide insurance in areas that might be damaged by riots.<sup>112</sup>

The problem, in the eyes of the Panel, was only an enlarged version of that faced by the urban areas plans; the remedy proposed by the Panel, and adopted almost intact in the federal legislation, was to try to neutralize, or at least to sharply reduce, the riot hazard as an underwriting consideration<sup>113</sup> by offering federal riot rein-

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110. In Detroit, drug stores and liquor stores incurred the greatest dollar losses, with grocery stores, clothing stores and laundries and dry cleaners also hard hit.

111. PANEL REPORT, *supra* note 3, at 6.

112. PANEL REPORT, *supra* note 3, at 88.

113. Other means of neutralizing the riot hazard as an underwriting consideration were advocated, but none proved viable. Despite some protestations to the contrary, the disturbances of the 1960's were generally considered to be "riots" within the meaning of the EC endorsement and not the "insurrections" excluded from coverage. Compare Comment, *Insurance Protection against Civil Demonstrations*, 7 B.C. IND. & COM. L. REV. 706 (1965) with Comment, *The Aftermath of the Riot: Balancing the Budget*, 116 U. PA. L. REV. 649, 692-702 (1968) and Note, *Compensation for Victims of Urban Riots*, 68 COLUM. L. REV. 57, 60-62 (1968). See also GENERAL ADJUSTMENT BUREAU, INC., INSURRECTION—RIOT, Aug. 4, 1967.

Proposals for insurers to provide insurance against riot damage apart from other property coverages in order to keep insurance against other property hazards available met with little approval from insurers and none from regulators, chiefly because of the acute problems of adverse selection and rating that necessarily would be involved in any separate packaging of riot and civil commotion coverage. See generally Note, *Compensation for Victims of Urban Riots*, *supra* at 65; National Underwriter (F & C), Nov. 3, 1967, at 8, col. 1 (remarks

surance to companies actually participating in state programs modeled after urban areas plans in states which made provision for funding a five per cent layer of the total reinsurance liability. Reinsurance alone would not solve the market problems, of course, but it was thought that by tying eligibility for reinsurance to active participation in state programs designed to increase property insurance availability, individual insurers might be induced to accept a sufficient measure of social responsibility to alleviate most of the urban market problems.

The responsibilities demanded of insurers participating in FAIR plans were similar in nature to those required by the plans' progenitors in New York, Detroit, Boston, and other cities. Participating insurers were to agree that

no risk shall be written at surcharged rates or be denied coverage for essential property insurance unless there has first been an inspection of the risk, without cost to the owner, by an inspection facility and a determination by the insurer, based on information in the inspection report and other sources, that the risk does not meet reasonable underwriting standards at the applicable premium rate. . . .<sup>114</sup>

As in the urban areas plans, the burden of inspection was spread through most of the property insurance industry by committing the duty to the rating organization in that state. Procedures assuring the applicant the right to request an inspection, allowing a tenant

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of J. Sammit, Executive Vice-President, Continental Casualty Company).

Extension of statutes fixing liability for mob damage on local governmental units received wide support among the commentators, but the realities of limited financial resources of local governments together with a healthy skepticism about the supposed deterrent effects of such liability made extension of the device to other jurisdictions unlikely. The best analyses are Rottman, *Riot Damage, Municipal Liability, and Insurance*, 1968 INS. L.J. 597; Comment, *Municipal Liability for Riot Damage*, 81 HARV. L. REV. 638 (1968), and Comment, *The Aftermath of the Riot: Balancing the Budget*, *supra* at 668-692. *Contra*, Jaffe & Dubin, *Trends in Municipal Liability*, 1967 INS. L.J. 282. See also Sengstock, *Mob Action: Who Shall Pay the Price*, 44 J. URBAN L. 407 (1967) (urging judicial imposition of municipal liability to individuals injured by negligent failure of municipal authorities to suppress riots).

In Newark, insurers were among those successfully seeking reimbursement from the city for claims arising from the 1967 riots. *National Underwriter (F & C)*, July 4, 1969, at 1, col. 1. On the equities and practical difficulties of permitting insurers subrogation rights under municipal liability statutes, see Note, *Compensation for Victims of Urban Riots*, *supra* at 74-75; and Comment, *The Aftermath of the Riot: Balancing the Budget*, *supra* at 702-08.

114. 12 U.S.C. § 1749bbb-3(b) (1) (1970).



an inspection even in the absence of the building owner, and requiring insurers to render a prompt underwriting decision were mandated by the federal enactment. The decision to accept or not accept a risk after an inspection again was left to the discretion of the individual insurer, but copies of both the inspection report and the action report were required to be forwarded to the state insurance authority to permit monitoring of each company's decisions, and each rejected applicant was given a right to appeal the decision of the insurer to insurance regulatory officials.<sup>115</sup> In addition, each FAIR plan, in order for its participants to be eligible for federal reinsurance, was required to include a mechanism for assuring that the burden of considering applications for insurance from inner city locations, and actually assuming risks deemed insurable, did not fall inequitably upon the companies. Under urban areas plans, some insurers had avoided contact with prospective insureds in urban cores by the simple expedient of not appointing agents to receive applications from such areas, and by discouraging existing agents from accepting such applications. The Panel proposed, and the federal statute required, that each FAIR plan include an "all-industry placement facility" to assist applicants for insurance in placing coverage up to the full insurable value of the risk and to distribute the risks involved equitably among participating insurers.<sup>116</sup>

### B. "Creative Federalism" Insurance Style

This vision of the availability problem meshed well with the underlying administrative approach recommended by the Panel. In constructing its proposals, the Panel was forced to mediate carefully between two imposing sets of pressures. On the one hand the Panel was confronted by a suspicious Washington wary of passing out federal benefits without substantial practical assurances that meaningful improvements in urban property insurance markets would result; on the other hand the Panel was faced by an industry and an established regulatory regime adamantly hostile to lodging any regulatory authority over the insurance industry in any federal agency. The Panel found its solution in the rationale of "creative federalism."<sup>117</sup> By specifying goals to be accomplished in exchange

115. 12 U.S.C. § 1749bbb-3 (1970).

116. 12 U.S.C. § 1749bbb-4 (1970).

117. Although the Panel apparently did not employ the term, the research director for the Panel, Herbert Denenberg, made clear that the proposals consciously were structured to accord with that rationale. Becker & Denenberg, *Implementing the National Reinsurance Program: The District of Columbia Insurance Placement Act*, 21 CPCU

for the provision of riot reinsurance and by leaving the existing industry-regulator axis free to administer itself in determining how to accomplish those responsibilities, the Panel hoped that it could construct a package that could be made to seem scarcely either "federal" or "regulatory."

Thus, the rhetoric of the Panel was the rhetoric of "cooperation," "partnership," and voluntary assumption of responsibilities parceled out by it to the cooperating groups. The federal role would be limited to providing the reinsurance structure necessary to protect insurers from catastrophic riot losses.<sup>118</sup> The industry, freed from that worry, as its part of the bargain would stop underwriting by area and would resume making underwriting decisions based on the merits of the individual risk. State government would share in the riot reinsurance back-up, and state regulators would prevent shirking of responsibility by individual insurers and assure that the industry put the necessary patches on the urban areas plans. The existing scheme of regulation would be preserved. Each partner in the undertaking would fulfill its responsibilities; each would do

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ANNALS 293, 294 (1968). See also Denenberg & Teberg, *Meeting the Insurance Crisis of Our Cities: The Theory and Reality of Legislative Reform*, 22 CPCU ANNALS 121, 131-35 (1969); MESSAGE FROM PRESIDENT JOHNSON TO THE CONGRESS, H.R. Doc. No. 251, 90th Cong., 2d Sess., 114 CONG. REC. 3956, 3959 (1968).

For perspectives on the sort of federalism variously labeled "new" or "creative," see A GREAT SOCIETY (B. Gross ed. 1968). The close connections between notions of corporate social responsibilities and the idea of "creative federalism" are apparent; Max Ways has explained the attractions to the business community in this way:

Creative federalism starts from the . . . belief that total power—private and public, individual and organizational—is expanding very rapidly. As the range of conscious choice widens, it is possible to think of vast increases of federal government power that do not encroach upon or diminish any other power. Simultaneously, the power of states and local governments will increase; the power of private organizations, including businesses, will increase; and the powers of individuals will increase.

Ways, "Creative Federalism" and the Great Society, FORTUNE, Jan. 1966, at 121.

For a devastating critique of this "ersatz public philosophy," see T. LOWI, *supra* note 19, at 38. But see, e.g., Fluno, *The Floundering Leviathan: Pluralism in an Age of Ungovernability*, 24 W. POL. Q. 560 (1971).

118. Concerns for both costs and speed supplemented the philosophical bases for avoiding a substantial federal role. See, e.g., Denenberg & Teberg, *supra* note 117, at 134; 1968 House Hearings, *supra* note 9, at 1077 (Mr. Wozencraft defending Panel's judgment that direct federal reinsurance was inappropriate because industry-based programs could be more quickly established and would permit avoidance of substantial federal costs).

its share; each would carry out its part of the bargain.<sup>119</sup> The Panel program was the beneficiary of almost unstinting praise.

However, the bill<sup>120</sup> that became the primary vehicle for the federal legislation that was to ratify the bargain dealt with a number of grubby matters of detail and dealt with them by committing substantial authority to the federal agency that was to administer the program. The Panel Report advocated that federal reinsurance be provided by an independent federal corporation managed by a board of directors composed of representatives of industry, the public, state regulators, and the federal government. The Panel envisioned that the corporation would have no regulatory powers that would disturb the established patterns of state regulation.<sup>121</sup> The bill that emerged not only made the corporation into an agency of the Department of Housing and Urban Development, but also conferred on it significant regulatory functions.<sup>122</sup> The bill gave the federal agency complete auditing and examination power over any reinsured company or FAIR program and the power to refuse reinsurance to an insurer if it was not fully participating in an acceptable program, to modify the standards of performance required for eligibility, including the authority to require addition of burglary and theft coverages to state plan requirements, and to

119. The language of bargain was remarkably explicit throughout the development of the programs. See, e.g., Insurance, November 16, 1968, at 34, col. 1: "[I]n essence, we traded a reinsurance back-up to remove catastrophic exposure in return for our commitment to write property insurance in the ghettos and blighted areas"; Denenberg & Teberg, *supra* note 117, at 124: "In its simplest terms then, the federal government and the states protect insurance companies from catastrophic riot losses in return for a fee and in return for their agreeing to make insurance available in the cities." See also 1968 House Hearings, *supra* note 9, at 1071, 1073.

120. H.R. 15625, 90th Cong., 2d Sess. (1968) ("The National Insurance Development Corporation Act of 1968"), reprinted in 1968 House Hearings, *supra* note 9, at 48-57. The companion Senate Bill was S. 3028, 90th Cong., 2d Sess. (1968).

121. PANEL REPORT, *supra* note 3, at 99-102.

122. The decision to make the Federal Insurance Administrator an agency of the Department of Housing and Urban Development apparently was prompted as much by the desire to fit the funding of any federal reinsurance liability within established channels of HUD borrowing authority under the National Housing Act as by any particular theory of administrative direction for the programs. See, e.g., Washington Ins. Newsletter, Feb. 26, 1968; Washington Ins. Newsletter, May 13, 1968; 1968 House Hearings, *supra* note 9, at 1082-86.

The House bill would have limited borrowing authority to \$150 million; the Senate bill imposed no limits. The compromise was borrowing authority to \$250 million and such further sums as might be authorized by joint resolution. 12 U.S.C. § 1749bbb-13(b) (1970), incorporating the limits and terms of 12 U.S.C. § 1735d(b) (1970).

specify the geographical areas the state plans were to serve. In the words of one of the state regulators who rushed to Washington to oppose this development, the agency was to be given "[e]xtremely broad powers to alter and shape the whole existing pattern of markets and regulation . . . without meaningful participation by the insurance industry or insurance regulators and without any means for Congress to establish and oversee the specifics of Federal policy."<sup>123</sup> The regulators and the industry presented a united front against the vesting of such powers in the federal agency.<sup>124</sup> Eventually, a compromise was hammered out. The reaction was a typical one for a program structured according to the governing rationale of creative federalism: the problem of aversion to the location of regulatory power in the federal government was handled, not by reducing the power, but by diffusing it and dispersing it. As a consequence, the Panel's "sophisticated allocation of responsibilities" grew even more splintered under pressure from state regulators and the major insurance trade associations. Representation of the industry and state regulators on the Advisory Board was increased, and the Federal Insurance Administration (FIA) in HUD was required to consult with the Advisory Board before taking certain actions.<sup>125</sup>

Conversion of the Panel's recommendations into a legislative package also had another, related, consequence. On one critical

123. 1968 *House Hearings*, *supra* note 9, at 1163 (testimony of Commissioner Parker).

124. 1968 *House Hearings*, *supra* note 9, at 1131-37 (AMIA objections); *id.* at 1116-1121 (NAII objections); *id.* at 1147-1158 (INA objections); *id.* at 1160-1191 (NAIC objections). *But see id.* at 1099 (chairman of AIA has no complaints concerning federal authority, but supports efforts of concerned insurers and regulators to obtain clarification of federal powers).

125. *See generally* 12 U.S.C. §§ 1749bbb-1, 1749bbb-6, 1749bbb-8, & 1749bbb-9 (1970). The alterations did not silence all detractors of the federal involvement. *See, e.g.*, Senate Comm. on Banking and Currency, Rep. No. 1123, 90th Cong., 2d Sess. 195-96 (1968) (minority views):

We do not consider these broad extensions of Federal power into the insurance industry necessary to carry out this program nor do we consider them desirable.

. . . .

It is argued that the Federal authority is justified because of the remote possibility that the riot losses covered by the program may exceed the exposure of the insurance industry, the required State contributions, and the reinsurance premium funds.

. . . .

[S]uch losses are not likely and can be avoided and . . . the remote possibility of a demand on Treasury funds is not sufficient to extend Federal regulatory power throughout the insurance industry.

question—whether the responsibilities of insurers participating in the state programs should include a guarantee of coverage—the Panel had waffled. For most of its report the Panel had seemed content to live with its diagnosis of the property insurance availability problem as one of area underwriting, and to accept the assurances of the industry that neutralizing the civil disorder exposure and rationalizing the burdens of inspection would result in particularized underwriting decisions that somehow would take the sting out of the availability problem. However, as expressed by the Panel, this anti-discrimination prescription was not unambiguous. With a disingenuousness that could not completely mask the significant antinomies it was obscuring, the Panel juxtaposed its conclusion that the availability problem resulted from “a failure to distinguish between good and bad risks”<sup>126</sup> with the hope that “all well-maintained property in the hands of responsible owners should be insurable without regard to environmental hazards.”<sup>127</sup>

Constructing a statutory scheme embodying the Panel’s administrative approach meant converting such broadly stated goals into formal conditions for eligibility for the riot reinsurance. If the Panel’s concept of “environmental hazards” were read to encompass only the riot exposure and the amorphous concerns behind unparticularized location-based inferences about the desirability of individual risks, the Panel Report could be seen as embodying a single prescription emphasizing the responsibility of insurers to make informed underwriting decisions without fear of civil disorders. However, in the federal legislation the Panel’s precatory sentiment was translated into a requirement that within two years participating insurers must stop making underwriting and rating decisions based on environmental hazards,<sup>128</sup> and “environmental hazard” was defined to include “any hazardous condition that might give rise to a loss under an insurance contract, but which is beyond the control of the property owner.”<sup>129</sup>

While not without its own ambiguities, the sweep of this definition insured that the implementation of the FAIR plans would not be easily accomplished. The requirement that the underwriting decisions of participating insurers not only be particularized but also ignore conditions that were “beyond the control of the property owner” at the least involved a rejection of the simplistic vision of the urban areas plans (and most of the Panel Report) of a property insurance world inhabited by unequivocally “good” and “bad” risks,

126. PANEL REPORT, *supra* note 3, at 88.

127. *Id.* at 96.

128. 12 U.S.C. § 1749bbb-9(a)(2) (1970).

129. 12 U.S.C. § 1749bbb-2(a)(4) (1970).

with conscientious consideration of the features of each risk all that public policy should require. Instead, the message of the statute became that insurers would be expected to write at standard rates a third category of risks that would be unacceptable in the voluntary market because of environmental hazards. The boundaries of that category, how the responsibility was to be allocated, and where the costs were to fall, as with other details of administration, all were left to be worked out in the process of implementation.

Thus, the programs established under the joint aegis of the Panel Report and the federal statute were characterized by a parceling of responsibility defined largely, in the case of insurers, in terms of a duty to participate, with but few standards to dictate the form and nature of that participation. Central questions concerning the role of individual insurers in the programs, the underwriting standards to be employed, and the pricing of the coverage to be provided, were simply deferred and delegated to the insurance industry, the state regulatory officials, and HUD, without any very clear boundaries on the responsibility. While this technique had the supposed advantage of locating the power of decision and the expertise in the same hands, in fact the decisions that were deferred often were not technical matters but rather broad questions of purpose and design. The result was threefold: (1) the layering of responsibility and its concomitant diffusion of authority placed the power of initiative in the industry and insulated many aspects of the program from effective control by public agencies; (2) there was a struggle for access to and control over the boards of governors of the state plans, often the real locus of authority; and (3) not surprisingly, the boards of governors felt as their primary concern a functional accountability to their constituent elements.<sup>130</sup> When the lure of riot reinsurance failed to live up to its advance billing as a strong inducement to full participation in the programs, it quickly became evident that the other instruments available to state and federal officials were ineffectually blunt, and that the emphasis on cooperation, partnership, and responsibility had obscured important differences among those shoehorned together in the programs. In the process of implementation, these difficulties would stretch thin the fabric of the rhetoric of cooperation and responsibility and protrude as real problems to be resolved.

### C. Who Governs: Authority, Accountability, and Control

#### 1. *The Limited Lure of Riot Reinsurance*

The near-unanimity with which the industry welcomed the ad-

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130. Cf. T. Lowi, *supra* note 19 (providing numerous examples of similar consequences of "interest group liberalism").

vent of the riot reinsurance program was soon to dissipate. Within three months after the federal statute had ratified the bargain, one of the principal leaders of the industry's pilgrimage to Washington was denouncing the accord as "almost . . . a 'pound of flesh' exacted by a 'shylock' government."<sup>131</sup> Similar and only slightly more temperate complaints soon followed.<sup>132</sup> By early 1970, even the Federal Insurance Administrator was opining in public that the insurers who "screamed for federal riot reinsurance sold their birth-right for a lousy mess of potage."<sup>133</sup>

The roots of the disenchantment lay in the structure of the federal reinsurance system. Despite its label and its superficial resemblance to commercial excess loss reinsurance, the contract offered by HUD<sup>134</sup> to participating insurers differed markedly from traditional reinsurance arrangements. The contract provided that each insurer would be subject to an annual net retention of riot losses incurred by it in any one state equal to 2.5 per cent of its direct earned premiums on reinsured lines in that state and that the insurer would participate in any losses in excess of its net retention according to a sliding scale ranging from ten percent to two per cent as excess losses grew. HUD, as reinsurer, would assume the remainder of the insurer's losses. However, HUD's participation was to be funded in the following order: first, out of accumulated reinsurance premiums generated in the state in which the insurer experienced the riot losses; then, if additional funds were required, out of assessments against other participating insurers in that state to the extent that their riot payments in the state for the year had not equalled or exceeded their net retentions; then, if still more funds were needed, out of the state government's commitment to back up the other layers with funds in an amount up to five per cent of the aggregate property insurance premiums earned in the state during the preceding calendar year on the lines of insurance reinsured with HUD during the year in which the

131. H. Clay Johnson, speech before 1968 annual meeting of the Independent Insurance Agents of California, *reported in* National Underwriter (F & C), Oct. 4, 1968, at 30, col. 4.

132. *See, e.g.*, National Underwriter (F & C), Oct. 11, 1968, at 53, col. 2. Kenney, *The Great Awakening to the Shortcomings of Federal Back-Up of Riot Insurance*, UNITED STATES INVESTOR, Oct. 7, 1968, at 63.

133. Insurance Advocate, Jan. 31, 1970, at 6, col. 1.

134. The first formal contract offer was published at 33 Fed. Reg. 11,077 (1968). For subsequent contracts consult 34 Fed. Reg. 642 (1969); 35 Fed. Reg. 6125, 6504 (1970); 36 Fed. Reg. 2475 (1971); 37 Fed. Reg. 8379 (1972); 38 Fed. Reg. 8076 (1973); 39 Fed. Reg. 13,018 (1974); 40 Fed. Reg. 14,351 (1975); 41 Fed. Reg. 13,648 (1976). The "Standard Reinsurance Contract" is found at 24 C.F.R. Part 906 (1976).

losses occurred; and finally, if still more funds were required, out of funds borrowed by HUD from the federal treasury, to be repaid with interest when sufficient reinsurance premiums became available.

As a consequence of this arrangement, the program operated not as a reinsurer but as twenty-seven separate sinking funds, organized and administered by the federal government, but involving no federal resources put at permanent risk.<sup>135</sup> While the program could help to redistribute the impact of riot losses among participating insurers in a particular state, it would not redistribute losses across state lines.<sup>136</sup> Thus, although the HUD borrowing authority held the promise of a guaranteed method of spreading at least a portion of the impact of a truly cataclysmic riot over time, almost all of the activity under the program involved redistributions of funds among insurers doing business in the state experiencing riot losses. Only if the funding of the state layer were to be broadly based and only if there were a reasonable likelihood that the state layer would be tapped did the federal program offer insurers benefits that could not have been achieved under private auspices without the intervention of the federal program.<sup>137</sup> Insurer disillusionment in large measure grew out of a burgeoning fear that neither of these conditions would be met.<sup>138</sup>

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135. Thus, the oft-quoted statements by the Panel that the riot reinsurance program was designed to "eliminate the riot risk as an impediment to the active participation of companies in the urban core insurance market" and to "neutralize the riot risk as a factor in insurance company underwriting decisions," PANEL REPORT, *supra* note 3, at 100, 102, should not have been misunderstood to mean that the riot hazard would no longer be borne by the insurance industry. Rather, the Panel's program operated to tie the fortunes of a state's participating insurers together so that whether or not an insurer wrote urban core properties, it would be bearing a share of the riot hazard of those written by any participating insurer. The riot risk was not being totally eliminated in the sense that an insurer could not avoid riot loss potentials by deciding to write one risk rather than another within the state.

For a general treatment of the implications of this arrangement see J. LEWIS, PROPERTY INSURANCE IN THE URBAN CORE 168-250 (Unpublished Ph. D. dissertation, U. Wisc. 1970). Lewis quite correctly refers to the federal role as "little more than a fiscal agent." *Id.* at 234. See also Launie, *A View of the HUD Reinsurance Plan with a Suggested Alternative*, 21 CPCU ANNALS 305 (1968).

136. Because an insurer's net retention and potential assessment liabilities were tied to its total writings within the state, the reinsurance arrangement was not calculated to recognize differences in particular insurers' riot exposures. Launie, *supra* note 135, at 308.

137. This assumes that loans of up to \$250,000,000 would be available to industry organizations. Treasury loans under the program would be made on commercial terms. 12 U.S.C. § 1735d (1970).

138. Insurer unhappiness also focused on the uniform rates and retentions



a. *Funding the State Layer*

The state backup layer requirement, part of the Panel's elaborate allocation of responsibilities, was chiefly an attempt to counter warnings that the Panel's program would be an invitation to unchecked arson and looting: "Maintaining law and order is primarily a state and local responsibility. Thus, any state desiring reinsurance for riot risks located in that state would be required to accept a state layer of financial backup of some kind in the event that disorders actually take place in that state."<sup>139</sup> The Panel suggested that the backup layer might be funded from general revenues or from existing or augmented insurance premium taxes, and that a state "might also wish to share its responsibility with units of local government to assure their continued cooperation in the maintenance of law and order and the prevention and control of riots."<sup>140</sup> The federal legislation followed the Panel's lead, requiring that statutory provision be made by each participating state for reimbursement of HUD by "the State, its political subdivisions, or a governmental corporation or fund established pursuant to state law."<sup>141</sup>

Most states proved reluctant to pledge state or local revenues to fund the layer. Some states simply decided that the reinsurance program was not worth the candle and opted out of the program. Other states, though determined to qualify their insurers for participation in the program, resisted funding the state layer out of

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applicable in all states; differing degrees of riot potential and varying distributions of business should be recognized, ran the argument. National Underwriter (F & C), Feb. 28, 1969, at 2, col. 1. For a report of a survey of similar dissatisfactions, see Lewis, *A Critical Review of the Federal Riot Reinsurance System*, 38 J. RISK & INS. 29 (1971). Cf. 1968 House Hearings, *supra* note 9, at 185 (state regulatory official urging that riot hazard be viewed as a national social problem and that the same reinsurance premiums and retentions should prevail in all states without regard to riot experience or potential).

139. PANEL REPORT, *supra* note 3, at 13. The recommendation also was designed to help allay fears that states not suffering riot losses somehow would be subsidizing riots in states unable to avoid such difficulties. *Id.* at 102.

140. *Id.* For an indication of the seriousness with which the "maintenance of law and order" rationale was received in some quarters, see the discussion by Senator Russell, 114 CONG. REC. 15122-25 (1968) (urging extension of the state layer requirement to include mandatory equal participation by municipalities in order to help discourage official decisions to let riot areas burn as a method of "cheap urban renewal"). See also National Underwriter (F & C), April 26, 1968, at 1, col. 4 (representative of rating organization urging use of riot exclusion endorsements in all policies written on governmental property).

141. 12 U.S.C. § 1749bbb-9(a) (1) (1970).

general revenues or by imposing an additional premium tax. Their hesitancy went beyond mere fiscal caution; the method chosen to fund the state layer could have important ancillary consequences. In theory, riot loadings were designed to produce enough premium dollars to pay for insurance of the riot peril, including the cost of any reinsurance the primary insurer in its business judgment might decide to purchase from either the federal program or from commercial reinsurers. Broadly based funding of the state layer would import a potential subsidy to insurers participating in the federal program and thus would prejudice the competitive positions of insurers seeking to handle their riot exposures through normal methods. From the viewpoint of HUD and insurers participating in the federal program, the result was a useful and justifiable inducement to full participation in the federal program. From the perspective of state regulators and nonparticipating insurers, the riot hazard already had been spread once through the loading so that the only question was

whether the public having already paid for the riot peril through the premium structure should be called upon, in addition, to pay for part of some insurer's losses through a funding device involving additional potential outlays of public money, either directly or through a premium tax borne only by the insuring public.<sup>142</sup>

A second consideration also colored the state regulators' perspectives. Broadly based funding of the state layer would permit HUD to use an artificially reduced reinsurance premium as an inducement to insurers to participate in the federal program and to rely on the state layer to make up any deficiency in the reinsurance rate.<sup>143</sup> A proposed model bill aired at the December 1968 meeting of the NAIC would have resolved both objections by funding the state layer through proportional assessments on insurers who participated in the federal program, thus making the cost of the state layer a part of the cost of the reinsurance and charging any inadequacy in the reinsurance rate to the insurers who benefited from the inadequacy. Industry trade associations voiced strong objections to this approach, the Acting Federal Insurance Administrator professed official neutrality though not private indifference, and the NAIC Committee to Study Civil Disorders, after cataloguing

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142. II 1968 NAT'L A. INS. COMMISSIONERS PROC. 93.

143. In fact, of course, the absence of serious riots has meant that state layers have not been tested. By 1970, reinsurance premium rates had been drastically reduced and revised assessment provisions in the HUD reinsurance contracts imposed a further reduction in protections against future state layer assessments. Despite annual reductions in reinsurance premiums, the reinsurance fund reserves eventually would exceed \$100,000,000.

the considerations, ultimately took no formal stand on the question.<sup>144</sup>

The official neutrality of HUD ended a few months later with the promulgation of an HUD rule dealing with the state layer requirement. Included was the following section:

Funds for the State share may be raised in any constitutional manner consistent with the intent of the Federal Act to place appropriate responsibility upon the State to share in property insurance losses resulting from riots or civil disorders. The Federal Act provides that the Secretary is to be reimbursed by the State, its political subdivisions, or a governmental corporation or fund established pursuant to State law. Thus, the State share should be financed out of general revenues or in some other manner which broadly distributes the burden of property insurance losses resulting from riots or civil disorders.<sup>145</sup>

Although the battles dragged on for many months, so that HUD eventually was forced to obtain congressional extension of the deadline for enactment of the state layer,<sup>146</sup> most states eventually fell into line. Five states funded the layer from general revenues; two employed a premium tax; one authorized state borrowing; most imposed assessments on all property insurers doing business in the state, to be recouped almost immediately through a premium surcharge on all property insurance. Only one state, Michigan, followed the proposed NAIC plan of assessing only those insurers who actually purchased federal reinsurance, but several states adopted a somewhat awkward intermediate position, assessing all insurers doing business in the state but not authorizing immediate premium structure recoupment.

#### *b. Reaching the State Layer*

Even where the state layer was broadly funded insurers soon discovered that the structure of the federal program, coupled with a changing pattern of riot losses, was producing results that made the "federal benefit" purportedly provided by the reinsurance system appear increasingly tenuous. The problem was not that industry leaders had succumbed to the uncritical assumptions of some early enthusiasts that the program would substantially nullify the influence of the riot hazard on insurer underwriting decisions; they understood that the program was designed to assure that most riot losses, regardless of magnitude, ultimately would be borne by the industry. Still, insurer attentions had been trained on obtaining pro-

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144. II 1968 NAT'L A. INS. COMMISSIONERS PROC. 93.

145. 24 C.F.R. § 1907.4 (1976).

146. 12 U.S.C. § 1749bbb-9 (1970).

tection of their surpluses against the prospect of riots of apocalyptic dimension. When the riot loss configuration in the years following 1967 began to change, with smaller, more scattered, more frequent outbursts in hundreds of cities replacing the much larger, more concentrated, less containable devastation of Watts, Newark, and Detroit, insurers began to view the benefits of their bargain with growing suspicion. In states with relatively low premium volumes and highly concentrated riot loss exposures, insurers could foresee the possibility of tapping the state layer; in states with high premium volumes and scattered riot exposures, the chances of reaching the state level appeared remote.

### *c. Civil Disorder Loadings*

A related development further complicated insurer assessments of the merits of participation in the programs, but ultimately did little to allay insurer suspicions that the riot reinsurance bargain had gone bad. In the rush of industry panic following the Detroit and Newark disasters, the rating bureaus proposed an unusual departure from traditional property insurance ratemaking procedures. Customary property insurance ratemaking separated losses into "normal" and "catastrophe" categories, with "catastrophe" losses defined as losses in excess of \$1,000,000 per occurrence. Adjustments to the "normal" portion of the rate were based upon "normal" losses for the preceding five or six years; adjustments to the "catastrophe" portion of the rate were predicated on "catastrophe" losses of a much longer period, usually from ten to twenty-five years. The majority of states permitted the use of projection factors to allow some recognition of apparent trends in loss experience, but a significant minority required strict justification of modifications solely on the basis of past experience.

The post-riot proposals argued that riot losses should be excised completely from the normal ratemaking procedures. Instead, insurers would receive the premiums necessary to cover riot and civil commotion losses through the imposition of a separate riot loading to be applied to a broad base of property insurance coverages throughout each state. This loading, based on a review of estimated loss experience between 1965 and 1967, was to apply to existing rates for fire and extended coverage, including special extended coverage and vandalism and malicious mischief endorsements, and for the multiple-line policies which include those perils. The only exemption from the loading was for farm property, but the loading was designed to differentiate on a judgment basis between properties in cities or counties with populations over 250,000 and all other properties, and between private dwelling properties

and all other classes of property.<sup>147</sup> If approved in all the states, the loading was expected to generate additional annual premiums of \$50,000,000 to well over \$100,000,000.

The arguments in support of this modification of rating techniques were simple. First, existing extended coverage endorsement rates were said to provide only negligible recognition of a riot peril of the nature experienced in the mid-1960's, so that use of normal ratemaking procedures would severely curtail the bureaus' ability to develop rates truly reflective of current potentials for property losses from riots and civil disorders.<sup>148</sup> Second, statewide distribution of the impact of the loading was said to be desirable because of uncertainty about where civil disorders might erupt in the future, inability of inner-city insureds to bear the full brunt of the additional premiums required, and an oft-expressed feeling that the loading should reflect a general responsibility for the social conditions that give rise to civil disorders.<sup>149</sup> NAIC sanction<sup>150</sup> spurred

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147. Thus, extended coverage endorsement rates for private dwelling properties and their contents were to be increased by a flat 1%; fire, extended coverage (including special extended coverage endorsements and vandalism and malicious mischief), or explosion, riot and civil commotion when written specifically, and vandalism and malicious mischief rates on all property categories except dwellings and farm property were to be increased by 2% in counties with a population under 250,000 and by 4% in cities and counties with a population of 250,000 or more. National Underwriter (F & C), Mar. 29, 1968, at 1, col. 2. For a general treatment of the loading program, see Whitman & Williams, *Environmental Hazards and Rating Urban Core Properties*, 37 J. RISK & INS. 419, 430-35 (1970).

148. Although riots have been a familiar phenomenon in the United States, severe insured property damage losses have not been so common. Prior to the Watts outbreak in 1965, most experience under the riot and civil commotion clause of the extended coverage endorsement was the product of labor related violence in the 1930's. The manager of the Fire Insurance Research and Actuarial Association, Kent H. Parker, was quoted as saying that prior to the 1960's, extended coverage endorsement rates gave no recognition to fire hazards from rioting. Whitman & Williams, *supra* note 147, at 430 n.20. Those authors point out that fire losses initially caused by riot or civil disorder probably were reflected in some measure in standard fire insurance rates. *Id.* The arguments concerning the loadings rarely reached the question of why "normal" riot losses of less than \$1,000,000 should be excluded from normal ratemaking procedures, a point of some interest inasmuch as insured dwelling riot losses did not reach \$1,000,000 even in Detroit.

149. See, e.g., Letter from Fire Insurance Research and Actuarial Association (FIRAA) to rating bureaus (No. 68-2, Jan. 15, 1968); J. LEWIS, *supra* note 135, at 302-08.

150. I 1967 NAT'L A. INS. COMMISSIONERS PROC. 327. The Panel recognized the arguments but neither approved or disapproved in its formal recommendations. PANEL REPORT, *supra* note 3, at 35.

implementation of the loading in more than half the states, though a few states altered the formula to accord with local regulatory officials' ideas of the proper way to distribute the incidence of the loading; in Maryland and in New Jersey, for example, the loading was made uniform throughout the state.<sup>151</sup> Other states proved balky. Arguments by the bureaus that a state's small number of metropolitan centers and low loss experience from the riot hazard were irrelevant because of the national scope of the riot problem seldom were persuasive. The South Carolina response was not atypical:

Approval or disapproval of rates filed must be based upon reasonable inferences fairly arising out of the facts established and may not rest upon speculation and conjecture. While social eruptions such as those encountered in Watts, Newark, Detroit, Baltimore and Washington may possibly occur here, the probability is that they will not.<sup>152</sup>

In this atmosphere, both state regulators and the bureaus attempted to tie the riot loading to voluntary assumptions of risks thought to involve riot hazard. Representatives of the bureaus repeatedly warned that riot and civil commotion coverage might be curtailed in the twenty-three states that had refused to approve the loading unless those states reversed their stances.<sup>153</sup> On the other side of the ledger, several states that had approved the loading rescinded the approval when confronted with restricted underwriting by insurers in potential riot areas.<sup>154</sup> A few states

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151. J. Com., Nov. 5, 1968, at 7, col. 8. In Michigan, at the urging of the Insurance Bureau, the loading was altered so that in counties of less than 100,000 population, one and two family dwellings were subjected to no loading and all other coverages were subjected to a 2% loading; in counties of more than 100,000, the loading was roughly one dollar per policy for homeowners and dwelling fire, and 6% on all other coverages.

152. Quoted in National Underwriter (F & C), July 28, 1968, at 2, col. 4.

153. See, e.g., National Underwriter (F & C), Oct. 25, 1968, at 1, col. 2 (representatives of FIRAA and Multiline Insurance Rating Board arguing that civil disorder exposure must be viewed as a nation-wide problem that cannot be limited to specific localities and thus that it is inequitable for policyholders in states with the loading to subsidize riot protection for policyholders in states without the loading).

154. The riot surcharge was approved with the understanding that those companies adding the surcharge to their premiums would not restrict their writings in areas of potential riots. Our experience, and it seems the experience of many states, has been exactly the opposite. . . . It is unconscionable to believe that an insurance company can increase its rates approximately 3% to cover riot losses and then nonrenew or refuse to accept risks in these areas.

Letter from Nebraska Director of Insurance, Benjamin Neff, to all property insurers licensed in Nebraska (August 1, 1968) (announcing

dropped the loading after the federal insurance program became operable, purportedly on the theory that it was rendered unnecessary by the availability of the federal reinsurance;<sup>155</sup> that FAIR programs were not activated in those states (and thus insurers did not become eligible for federal riot reinsurance) suggests that anticipated low levels of riot activity in their states and the desire not to "subsidize riots" in other states may have played a larger role in the decision to terminate the loadings.

Out of this haphazard development came not only a promiscuous pattern of redistribution of the burden of paying for the riot hazard<sup>156</sup> but also a nearly indiscriminate distribution of the proceeds of the loadings. If the gradations in the loadings adequately reflected differentials in riot hazard,<sup>157</sup> and if the loadings were in effect nationwide,<sup>158</sup> the loadings would be reasonably distrib-

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withdrawal of approval of the loading). See also National Underwriter (F & C), Aug. 16, 1968, at 54, col. 2 (two New York broker associations urging New York Department of Insurance to rescind loadings in that state unless contraction of the voluntary market is reversed).

155. See, e.g., J. Com., Nov. 27, 1968, at 5, col. 6 (Florida removes loading, citing presence of federal reinsurance as obviating need for the loading); Weekly Underwriter, Jan. 11, 1969, at 6, col. 1 (Alaska ends loading, citing same considerations).
156. Of course, access to federal reinsurance did not obviate the need for premium dollars to pay for the reinsurance protection and to support the retained riot exposure. Elimination of the riot loading did not mean that rates would not contain provision for the riot hazard; it simply meant that riot losses would be recognized as part of insurers' total experience in the traditional manner in which losses—both "normal" and "catastrophe"—were recognized. But see statement by Hunter Van Lear, chairman of FIRAA, J. Com., Oct. 20, 1969, at 9, col. 1.
157. Distribution of the proceeds of the loading to insurers in proportion to their exposure to the riot hazard was, of course, only one of a number of "reasonable" bases of distribution. Another would have been to allocate the funds so collected as far as necessary on the basis of riot losses incurred, with any excess loading premiums distributed according to exposures.
158. National Underwriter (F & C), Jan. 17, 1969, at 1, col. 1 (statement by managers of three major rating boards acknowledging a supposed ethical base for spreading riot losses across property insurance nationally); Whitman & Williams, *supra* note 147, at 429-30, 432; J. Lewis, *supra* note 135, at 394-407.

Considerations of inter-state equity loomed large in privately expressed dissatisfaction with the loadings. For evidence that neither irregular acceptance of loadings filed nationwide nor fulminations about the resulting pattern of subsidization are anything new, consult 50 NCIC Proc. 161-73 (1919) (dispute over mixed acceptance of 10% property insurance surcharge promulgated by the National Board of Fire Underwriters to recognize the inchoate hazards of World War I).

uted when collected by each insurer for its own direct business. Clearly, however, in the real world the loading formula gave effect to a broadly redistributive theory of funding for the riot hazard. The consequent distribution of the riot loading funds was skewed in favor of those insurers who write a larger proportion of their voluntary business in areas with low riot potentials.<sup>159</sup> Perhaps more importantly, in the absence of major riot losses, the loadings allowed a significant general increase in the premiums collected by insurers which might soften the impact of nonriot losses on risks written through the programs. Nevertheless, the loadings were hardly a major inducement to participation in the state programs, and they added still further complications to the gaming aspects of the risk selection process.

For such reasons, the promised near-universal participation in the programs did not occur. Two major insurers chose not to participate at all in states where the programs were voluntary.<sup>160</sup> The National Association of Independent Insurers announced that its members would decide whether to participate on a state-by-state basis depending upon the apparent riot exposure and the character of the program. In sixteen jurisdictions no programs were organized;<sup>161</sup> in another eight states, programs were allowed to die.<sup>162</sup> In other states, despite the hortatory efforts of the American Insurance Association, the American Mutual Insurance Association, and regulatory officials, participation remained low.<sup>163</sup> Eventually, a

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159. Of course, if virtually all properties subject to riot hazard were written through the FAIR program and their experience distributed among insurers according to premiums written in the state, the results might be quite different. Under such circumstances an insurer with voluntary writings centered in counties with small populations might receive proportionally fewer loading dollars with which to meet the riot hazard assumed. Whitman & Williams, *supra* note 147, at 434. Whitman and Williams argued for a formal accounting system to reduce the impact of this problem but their proposals did not face up to the difficulties of determining the distribution of insurer exposure to riot losses. *Id.* at 432-34. See also Whitman, *The Insurance Problems of Small Business in Economically Poor Areas of the Twin Cities*, 21 CPCU ANNALS 323, 336-37 (1968).
160. Allstate and the Continental Insurance Group. Washington Ins. Newsletter, Nov. 11, 1968, at 8.
161. Alabama, Alaska, Arizona, Idaho, Maine, Mississippi, Montana, Nebraska, Nevada, New Hampshire, North Dakota, Oklahoma, South Dakota, Utah, Wyoming and the Virgin Islands.
162. Arkansas, Colorado, Florida, Hawaii, South Carolina, Tennessee, Texas, Vermont, and West Virginia.
163. A survey in early 1969 disclosed that in the 21 states with voluntary plans the percentage of eligible premium volume covered by the plans ranged from 57% to 99%, and the percentage of eligible companies participating ranged from 36% to 99%, with the average premium



wave of state statutes, supported by portions of the industry, made participation mandatory in all but two of the states maintaining programs.<sup>164</sup>

### 3. *The Limits of Public Direction and Control*

The statutory conversion of the programs from voluntary to mandatory did little to alter the ideology of the programs or the wide dispersal of practical capacity to shape their development.<sup>165</sup> The statutes were viewed as technical adjustments to assure full participation, and the programs remained a hydra-headed structure of mixed and overlapping imperiums. On some issues, federal or state regulators could expect to exert considerable guidance; on others, the boards of governors and their advisory groups and subcommittees would prove to be "islands of functional power,"<sup>166</sup> effectively insulated from close public direction and control, and responsive chiefly to the assumed dictates of voluntarism and the compulsions of adjusting the impacts of the programs on participating members of the industry.

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volume approximately 82%, and the average company participation about 73%.

164. CAL. INS. CODE §§ 10098 (West 1972); CONN. GEN. STAT. ANN. § 38-114f(b) (West Supp. 1976); DEL. CODE tit. 18, § 4109(a) (1975); D.C. CODE ANN. § 35-1705 (Supp. 1976); GA. CODE ANN. § 56-3202a (1971); ILL. ANN. STAT. ch. 73, § 1065.72 (Smith-Hurd Supp. 1976); KAN. STAT. ANN. § 40-2111 (1973); KY. REV. STAT. ANN. § 304 (Baldwin 1971); LA. REV. STAT. ANN. § 22:1433 (West Supp. 1976); MD. INS. CODE ANN. § 478C(1) (1972); MASS. GEN. LAWS ANN. ch. 175c, § 2.4 (West 1972); MICH. COMP. LAWS ANN. § 500.2920(1) (Supp. 1976); MINN. STAT. ANN. § 65A.35(1) (West Supp. 1976); MO. ANN. STAT. § 379.835 (Vernon Supp. 1976); N.J. REV. STAT. § 17:37A-3 (Supp. 1976); N.M. STAT. ANN. § 58-27-3 (1975); N.Y. INS. LAW § 652 (McKinney Supp. 1976); N.C. GEN. STAT. § 58-173.19 (1975); OHIO REV. CODE ANN. § 3929.43(A) (Page Supp. 1975); ORE. REV. STAT. § 735.045 (1975); PA. STAT. ANN. tit. 40, § 1600.201(a) (Purdon 1974); R.I. GEN. LAWS ANN. § 27-33-2 (Supp. 1976); VA. CODE § 38.1-750(1) (1976); WIS. STAT. ANN. § 619.01(1) (c) (West Supp. 1976).

165. See notes 183-209 and accompanying text *infra*.

166. The phrase is drawn from W. SAYRE & H. KAUFMAN, GOVERNING NEW YORK CITY ch. 19 (1960). For an elaboration of the consequences of the "public philosophy" that produces this arrangement, see T. LOWI, *supra* note 19, at 85-97: "(1) the atrophy of institutions of popular control; (2) the maintenance of old and creation of new structures of privilege; and (3) conservatism, in several senses of the word." *Id.* at 86. All were evident in the administration of the FAIR plans. See also SELZNICK, LAW, SOCIETY, AND INDUSTRIAL JUSTICE 240 (1969) (warning that such "privatization of public policy" imposes excessive social costs because it does not allow consideration of "more comprehensive needs and aspirations"); G. MCCONNELL, PRIVATE POWER AND AMERICAN DEMOCRACY (1967).

a. *HUD Regulation*

HUD's position at the top of the administrative charts did not mean that it would dominate the programs. The bargain ratified by the federal legislation by design denied HUD direct control over most of the underwriting and pricing approaches to be employed in the programs,<sup>167</sup> and in other areas of concern left HUD's statutory charter often debilitatingly vague. In addition, at least initially, the layered and dispersed administrative structures of the programs also imposed restrictions. The problem was not so much the formal system of consultations with state regulators and advisory groups built into the federal statute; those requirements usually could be finessed or ignored. Rather, the more telling constraint on HUD initiatives was posed by the bluntness of its regulatory weapons for dealing with the attenuated administrative structures of the programs.

The impressive capacity of the programs to resist direct regulatory efforts by HUD was demonstrated early in the history of the programs by a running dispute precipitated by HUD efforts to secure information about the operating practices and results of the FAIR plans. Although the statute granted HUD clear authority to require such records as it deemed necessary,<sup>168</sup> to conduct audits,<sup>169</sup> and to place such terms and conditions on reinsurance as it deemed necessary,<sup>170</sup> and although HUD was both explicit and persistent in its demands for more detailed reporting, HUD's demands often seemed to get lost in interstices between state regulators, boards of governors, and the specialized subcommittees and technicians who actually ran the plans.<sup>171</sup> At times, they were

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167. See, e.g., 1968 *House Hearings*, *supra* note 9, at 1090-91 (colloquy between panel member Wozencraft and Congressman Brown); *Hearings on the Operation of the Urban Property Protection and Reinsurance Program Before the Subcomm. on Housing of the House Comm. on Banking and Currency*, 91st Cong., 1st Sess. 46-58 (1969) [hereinafter cited as 1969 *House Hearings*] (discussion of FIA perceptions of allocation of authority between FIA and state regulators).

168. 12 U.S.C. § 1749bbb-14(a) to 14(c) (1970).

169. 12 U.S.C. § 1749bbb-14(d) (1970).

170. 12 U.S.C. § 1749bbb-8(c) (1970).

171. See, e.g., Statement of George K. Bernstein, Federal Insurance Administrator, to the Civil Disorders—Insurance Problems Committee of the NAIC, Dec. 2, 1969, in 1 1970 NAT'L A. INS. COMMISSIONERS PROC. 127, 129:

I regret to report that the statistics we have received are relatively meaningless. They are unclassified, showing not even the most elementary breakdown between commercial and dwelling risk. . . . Without more detailed and meaningful statistics, it is impossible for us, the Commissioners, or the companies to determine how good or how bad the experience

ignored or labeled irrelevant or impossible to achieve. Despite HUD's exasperation, its enforcement options were few. The lure of reinsurance was supposed to induce satisfactory cooperation. When it did not, the only sanction available to HUD was the ultimate one: to declare the offender not eligible for riot reinsurance. Especially where the action demanded by HUD was to be taken by the program rather than by an individual insurer, the threat of such drastic sanctions rarely was likely to seem credible.

HUD's reaction to the intractability of the administrative structure took several forms. In 1969 it sought and obtained congressional authorization and funding for an Office of Review and Compliance to aid in monitoring FAIR plan activities.<sup>172</sup> The new office permitted HUD to avoid many of the protocols of the formal administrative hierarchy of state regulators, governing boards, subcommittees and advisory boards, and to meet directly with operational personnel of the programs.<sup>173</sup> A second HUD initiative had a similar focus. HUD promoted formation of an "all-industry" FAIR Plan Advisory Board to help to unify plan procedures and rules; the idea was increasingly attractive to an industry grown sensitive to efficiency concerns and wary of the complexities of operating under a variety of different state patterns. From HUD's point of view, the Advisory Board offered the promise of reducing the number of plan variations and the number of separate battles that HUD would be required to fight at scattered pressure points throughout the bureaucracy.

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was and what lesson, if any, can be drawn for future operations. Apparently we must spell out for the FAIR Plans even the basic information which is essential, not only to your review and ours of their operation, but to their basic understanding of whether they are making or losing money.

See also *id.* at 130 (interim report of FAIR Plans Procedural Advisory Committee, including discussion of work of Accounting Subcommittee); FAIR PLAN PROCEDURAL ADVISORY COMMITTEE, UNIFORM FAIR PLAN PROCEDURES (May 15, 1970). But see *Hearings on Housing and Urban Development Legislation before the Subcomm. on Housing of the Comm. on Banking and Currency*, 91st Cong., 2d Sess. 345, 350-53 (1970) [hereinafter cited as 1970 House Hearings]; Letter to National Committee on Property Insurance from FIA (Jan. 26, 1972), in REPORTS ON FAIR PLAN OPERATIONS 1971, *supra* note 68 (reciting continued FIA complaints about failures of FAIR Plans to complete quarterly reports).

172. Urban Growth and New Community Development Act of 1970, Pub. L. No. 91-609, 84 Stat. 1791 (1970) (codified as 12 U.S.C. § 1749bbb-6a (1970)).
173. See, e.g., REPORTS ON FAIR PLAN OPERATIONS 1971, *supra* note 68 (limited to California, Connecticut, District of Columbia, Illinois, Massachusetts, New Jersey, New York, Ohio, Pennsylvania, and Rhode Island); a series of reports on individual FAIR plans conducted in 1973 (on file with author).

Such measures could improve HUD's monitoring of the programs and make the administrative structure appear less refractory. They also had a related consequence. HUD reports of inspections of state programs and communications with the advisory board could summarize HUD findings and signal conditions and practices deemed unsatisfactory or questionable without the need to cast the HUD objection as a direct interdiction or command. As HUD concerns widened, often ranging rather clearly beyond the narrow limits of its statutory charter, the usefulness of mixing suggestions and observations with direct imperatives inevitably would become more apparent. Nevertheless, though on the large questions within its jurisdiction HUD got its way, the system was not one in which fine tuning from the top of the administrative hierarchy was easy. In large measure, the HUD regulatory style, probably only partly by choice, was to remain the regulation of admonition, cajolery, and public hortatory preachments.

Substantively, HUD's concerns appeared to evolve as the programs matured. Initially, both the limits of its statutory commission and the press of immediate awkwardnesses in the infancy of the programs kept HUD attentions fixed primarily on eliminating barriers to applicant access to the programs and on issues of efficiency and effectiveness. Securing the adoption of binding procedures, improving the collection and reporting of program experience, and reduction of administrative expenses were at the center of the early HUD agenda.<sup>174</sup> Gradually, as the programs stabilized and as inspections by the Office of Review and Compliance provided details of program procedures, HUD dissatisfactions with the efficiency, public access, and accountability displayed by the programs increasingly were translated into informal pressures for the centralization of program underwriting, claims adjustment, and other functions. Although HUD regulations continued the interpretation that permitted the programs a variety of organizational forms,<sup>175</sup> by 1971 HUD regularly was urging the boards of governors to convert the programs to a syndicate form of organization.<sup>176</sup>

While the HUD amalgam of prescription and counsel could be remarkably detailed on some matters, its ventures into questions

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174. 1969 *House Hearings*, *supra* note 167, at 2-24 (testimony of Acting Federal Insurance Administrator Ross); 1970 *House Hearings*, *supra* note 171, at 340-81 (testimony of Federal Insurance Administrator Bernstein); *REPORTS ON FAIR PLAN OPERATIONS* 1971, *supra* note 68.

175. "The Plan's placement program may take any of a variety of forms; for example, it may involve a syndicated or direct writing pool, an assigned risk facility, a reinsurance pool or association, or combinations of the foregoing." 24 C.F.R. § 1905.4 (1976).

176. II 1971 NAT'L A. INS. COMMISSIONERS PROC. 573, 576.

of program coverages and prices initially were much more tentative. In 1970, HUD was bloodied in a confrontation with the NAIC over authority to define the "urban areas" in which the programs would operate,<sup>177</sup> and on other occasions suggestions of HUD efforts to dictate coverage requirements were met by rumblings from the states.<sup>178</sup> Formally, HUD regulations required only that underwriting standards for acceptance by the programs be predicated on objective features of individual risks<sup>179</sup>—excluding environmental hazards, of course—and they danced carefully around the question of whether the programs could be compelled actually to provide coverage for the full insurable value of "acceptable" risks.<sup>180</sup>

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177. The story is recorded in *National Underwriter* (F & C), July 3, 1970, at 2, col. 1. Proposed 24 C.F.R. § 1905.21 would have defined "urban areas" covered by the programs to include all incorporated places and all unincorporated places with populations in excess of 2,500. 35 Fed. Reg. 5820 (1970). The NAIC resisted, with the backing of insurer and producer groups, so that in the final regulations the definitional problem was left to the states, subject to a prohibition against confining them to "blighted" areas and a requirement that each plan "specify—by name, by population size, or by class—the political subdivisions and other areas eligible, if the entire state is not eligible." 24 C.F.R. § 1905.3(b) (1976).

178. Thus, the 1970 proposed regulations purported to authorize HUD to designate any property insurance as "essential property insurance" within the federal program. Proposed 24 C.F.R. § 1905.1(7), 35 Fed. Reg. 5817 (1970). The proposal was attacked as inconsistent with the limitations on HUD powers embodied in the federal statute in that it did not limit the perils that could be designated to "fire, EC, vandalism, malicious mischief, burglary, and theft." In the final rules, the FIA required state programs to make vandalism and malicious mischief available unless availability of such coverages was certified by state regulators but backed away from the language that had prompted the objections. 24 C.F.R. § 1905.3(a) (1976).

179. Reasonable underwriting standards for declination of risks must be relevant to the perils against which insurance is sought. For example, they may include:

(1) Physical condition of the property; however, the mere fact that a property does not satisfy all current building code specifications would not, in itself, suffice;

(2) The property's present use, such as extended vacancy (other than for rehabilitation purposes) or the improper storage of flammable materials; or

(3) Other specific characteristics of ownership, condition, occupancy, or maintenance that are violative of law or public policy and that result in a substantially increased exposure to loss.

24 C.F.R. § 1905.7(c) (1976).

In 1975, HUD invoked this standard in attacking the practice of the Missouri FAIR plan to deny liability where misrepresentations concerning tax obligations were discovered in the original application. See generally 40 Fed. Reg. 41550 (1975).

180. Although the federal enactment gave HUD authority to prescribe pro-

On the rating front, the statutory history unequivocally reserving to the states the major questions of how program coverages were to be priced seemed to restrict HUD's role to assuring that rates applied in the programs did not reflect environmental hazards. The HUD position applied the statutory language literally: eligibility for riot reinsurance required that the programs neither underwrite nor rate on the basis of any hazardous condition "beyond the control of the property owner."<sup>181</sup> It thus prohibited the application of exposure charges not only for the amorphous "social hazards" of deteriorating areas, but also for a variety of external exposures traditionally recognized in schedule rating. According to HUD, the statute had declared proximity to fire traps and dynamite factories irrelevant for rating purposes, and HUD moved quickly to secure program compliance with this vision.<sup>182</sup> The HUD interpretation was not universally shared, but the flat explicitness

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grams in addition to the FAIR Plans "to make essential property insurance available without regard to environmental hazards," 12 U.S.C. § 1749bbb-9(a) (2) (1970), upon findings that such programs had become necessary, HUD has never formally made such a finding nor required such programs. In fact, HUD did

not interpret that section as contemplating a guarantee of coverage as such, any more than essential coverage is guaranteed to particular properties by [the FAIR Plans] . . . . What [that section] is essentially saying, in our view, is that if the FAIR Plan approach to availability either fails or requires substantial modification, then the Secretary has authority . . . to prescribe some other approach to accomplish the same basic purpose. We cannot say that other programs in addition to or in place of FAIR Plans will never be necessary, but to date all of our regulations dealing with essential property insurance availability have been related to FAIR Plans as such.

Letter to Author from George K. Bernstein, Federal Insurance Administrator (May 19, 1972).

In practice, this putative distinction between requiring that state programs give access to the required insurance coverages and requiring that they actually provide coverage has remained obscure. HUD regulations require that state placement programs must, "for properties meeting reasonable underwriting standards . . . [p]lace insurance up to the full insurable value of the risk," but permit the programs to simply "assist in seeking to place the excess portion" of large risks in excess of \$1.5 million. 24 C.F.R. § 1905.4(c) (1976).

181. 12 U.S.C. § 1749bbb-2(a) (1) (1970).

(b) No surcharge shall be made on any risk unless it is based upon an appropriate, objective, and identifiable physical condition of the property, as disclosed by an inspection and specified in an inspection report, and no surcharge shall be made on the basis of environmental hazards.

24 C.F.R. § 1905.7 (1970).

182. Letter to Author from George K. Bernstein, Federal Insurance Administrator (June 26, 1972); *REPORTS ON FAIR PLAN OPERATIONS 1971*, *supra* note 68; 1969 *House Hearings*, *supra* note 167, at 5.

of the statutory language meant that in any confrontation with state regulators and industry the HUD position would prevail. Eventually, as we shall see, as HUD interest in program pricing grew, the necessity of viewing pricing questions through the narrow window of the environmental hazard prohibition would force upon HUD a perspective that would significantly influence the way it would frame its attitude toward a much broader range of issues concerning the programs and voluntary market pricing and underwriting practices.

### b. *State Regulation*

State regulation of the programs, where a factor, tended to mirror both the limitations and the preoccupations of the federal involvement. The federal statute allowed state regulators to certify to HUD that a particular insurer, or the entire FAIR plan, was not functioning properly, and thus to precipitate the cutoff of federal riot reinsurance.<sup>183</sup> However, though this power to police the programs against shirkers might be effective in the rare case of a clear and flagrant deviation from the federal standards, it afforded little help to a regulator interested in the far more common problem of trying to initiate changes in the operations of the programs or in the standards by which individual insurer performance would be judged. State regulators, if they chose, could try to check inspection reports against action reports in order to find patent underwriting abuses, and could hear the rare appeals from decisions of the boards of governors,<sup>184</sup> but they found it much more difficult to secure adoption of better binding arrangements, higher coverage limits, and similar alterations in program operating procedures.

The problem was that the "private" character of the programs, even in states that provided extensive statutory underpinnings, often meant that powers of initiative resided chiefly in the boards of governors of the programs. In states with voluntary programs, formal powers of initiation lay solely with the boards of governors, subject only to whatever suasive force the regulator could squeeze from the federal certification provisions and his state's boilerplate

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183. 12 U.S.C. § 1749bbb-9(a) (3) (1970).

184. In fact, despite the suggestion of the Panel that state insurance departments should be expected to monitor underwriting decisions under the programs by comparing action reports with inspection reports on declined risks, PANEL REPORT, *supra* note 3, at 93, little such activity occurred, chiefly because there usually was no way to review underwriting decisions except to retrace the steps taken by the inspection agency. State regulators, probably wisely in view of the small volumes of declinations in most states, simply did not invest resources in providing this sort of oversight.

provisions establishing minimum standards for doing business within the state. Moreover, legislation requiring participation in the programs seldom went beyond authorizing the joint features of the programs, mandating participation by insurers, and conferring immunity on participants for erroneous statements they might make in the conduct of programs.<sup>185</sup> Even in the few states where legislation gave state regulators the power to impose amendments, regulatory proposals could get lost in study commissions and technical subcommittees,<sup>186</sup> or be openly resisted by whipsawing calls for national uniformity on the grounds of efficiency and for deference to HUD as the arbiter of what should be required of state programs. Where state regulatory officials were willing to force an issue, industry opposition sometimes could delay implementation for years.<sup>187</sup> On less significant issues on which regulatory officials

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185. See, e.g., MO. REV. STAT. §§ 379.810-.880 (Supp. 1976); INDUSTRY PROPERTY INSURANCE LIAISON COMMITTEE, MODEL UNIFORM BASIC PROPERTY INSURANCE INSPECTION AND PLACEMENT PROGRAM (July 31, 1968), reprinted in II 1968 NAT'L A. INS. COMMISSIONERS PROC. 443. A later version of the Model Bill is reprinted in *Hearings Before the Subcomm. on Business and Commerce of the Senate Comm. on the District of Columbia*, 90th Cong., 2d Sess. 239-41 (1968). The industry-supported legislative approach continued the assumptions that had guided the Urban Areas Plans, modified only to enforce full participation; it thus accorded state regulators no more leverage than already provided by the federal riot program. The most interesting confrontation of this philosophy with regulatory assertions of authority occurred in the District of Columbia, where the battle was fought in the full glare of a Congressional hearing. See *id.*, especially at 241-49 (memo setting out objections to the industry's model bill); Becker & Denenberg, *supra* note 117, at 302. In Florida, a bill to permit the Commissioner to establish mandatory pools for a wide range of coverages was amended to authorize only "sinkhole" pools. BEST'S REVIEW (P & L), July 1969, at 5. The same basic scenario, with varying results, was played out in a number of states.

186. Industry representation on the boards of governors tended to be divided among the major insurer trade associations with added representation for domestic stock and mutual insurers. Because the representatives usually were executives of major insurers, the boards met only infrequently, and various technical subcommittees were established to act as an intermediate level of authority. This layering of responsibility and authority not only served to impede regulatory control, it also opened the programs to the criticism that attitudes of "corporate responsibility" asserted at the higher reaches of the bureaucracy did little good if they could not filter down to the operational level. See, e.g., National Underwriter (F & C), Jan. 5, 1968, at 1, col. 1 (brokers criticizing New York Urban Areas Plan on such grounds).

187. For example, despite the presence in each case of a clear statutory authorization, decisions by two state regulators to include vandalism and malicious mischief coverages before HUD instituted the requirement among those provided by the programs in their states were de-



were unwilling to wage extended legislative or judicial campaigns, state regulators often found themselves employing the cajolery and jawboning that had characterized preprogram attention to availability concerns.

Moreover, in most states the location of regulatory authority over program rates in state officials did not constitute a significant source of regulatory leverage. Whatever the reality, the ethic of insurer participation embodied in the "voluntary" programs implied that the risks to be written in the programs were risks that should be voluntarily assumed as "incident to" the normal market. Statutes converting programs from voluntary to mandatory usually did not reach the rate question, thus preserving the not-so-amiabile fiction that the character of the risks and the pricing scheme would be the same in both the voluntary and the residual markets.

In practice, however, there were differences. Existing substandard and excess rate filings were dusted off or new ones submitted for approval, so that extra charges on class rated structures and after charges on schedule rated structures could be applied by inspectors.<sup>188</sup> In order to pass federal muster, such schedules were equally applicable to risks written in the voluntary market. Nevertheless, inspections of class rated properties almost always were limited to those seeking coverage in the programs and reinspection of schedule rated property rarely occurred except for those properties headed for the programs. The majority of inspected properties were given condition charges. Consequently, properties written through the program tended to generate more premium than if they had been written in the voluntary nonsurcharged market. Did the application of such charges constitute a surreptitious charge for "environmental hazards"? State regulators seem to have been more concerned with assuring that condition charges actually were

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layed for nearly two years by court actions based on the theory that the state program was "part of a joint state/federal program . . . geared to and dependent upon the availability of reinsurance under the National Insurance Development Program." *New Jersey Ins. Underwriting Ass'n v. Clifford*, 112 N.J. Super. 195, 199, 270 A.2d 723, 725 (1970) (resolved chiefly on the grounds that the statutory structure of the New Jersey Underwriters Association disclosed that it was designed to operate independently of the federal statute); *District of Columbia Ins. Placement Facility v. Washington*, 265 A.2d 45 (D.C. Ct. App. 1970) (recognizing superintendent's authority to prescribe by rule additional coverages not required by HUD, but declaring rule invalid for failure to comply with notice and hearing procedures of Administrative Procedures Act).

188. For a description, see Whitman & Williams, *supra* note 147, at 424-26; Whitman & Williams, *FAIR Plan and Excess Rate Plan Rates in Minnesota*, 38 J. Risk & Ins. 43 (1971).

applied to specific deficiencies in the property rather than as an automatic surcharge for all program property; in the few instances when they formally addressed the propriety of the charges,<sup>189</sup> the primary concern seems to have been that the charges not be duplicative. The environmental hazards question was left to HUD.

A distinctly different approach, at first tried only in New York, called for self-rating of the residual property pool business. Rating classifications were maintained, and extra and after charges could be applied, but the rate level would be adjusted annually, "based on the association's loss and expense experience."<sup>190</sup> Put simply, the New York Insurance Department did not credit the notion that risks became program risks solely because of environmental hazards, informational deficiencies, or anti-social insurer conduct. Unhappy experience with the New York urban areas plan had demonstrated to the Department that even with inspections, insurers did not want to write a substantial portion of the risks.<sup>191</sup> The New York solu-

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189. See, e.g., Letter from George F. Reed, Pennsylvania Insurance Commissioner, to H. Richard Heilman, Chairman of Board of Governors of Pennsylvania FAIR Plan (Jan. 13, 1970) (directing FAIR Plan to put into effect simplified schedule of charges, and urging that public statements by the FAIR plan avoid the term "surcharge" with its suggestion of automatic penalties for all FAIR plan risks) (in files of Author). In Illinois, for a time, what amounted to a flat surcharge was employed; it was eliminated under federal pressures examined in notes 232-35 and accompanying text *infra*.

190. N.Y. INS. LAW § 653(3) (McKinney Supp. 1976) made FAIR plan rates subject to the usual property insurance rating standards, except that yearly filings were required "based on the association's loss and expense experience, together with such other information as the superintendent may require," and association filings were freed from the usual requirement that they be predicated on five year's experience. Filed rating plans could continue to provide standards for the application of surcharges for risks containing unsafe or hazardous conditions. Eventually, under the pressure of adverse experience, a form of self-rating also was adopted in Illinois, Minnesota, and Wisconsin. See also Insurance Advocate, Jan. 8, 1977, at 1, col. 2 (Massachusetts FAIR plan seeking 50% experience based rate hike); National Underwriter (P & C), Mar. 18, 1977, at 1, col. 2 (Massachusetts rate increase denied on basis of "principle that no policyholder should be surcharged without being given an objective reason").

191. Compare FIRE INSURANCE IN CONGESTED AREAS I, *supra* note 38, (identifying area underwriting as "primary cause" of availability problems) with FIRE INSURANCE IN CONGESTED AREAS II, *supra* note 97, at 24 (recognizing that lack of information and antisocial insurer behavior are not at heart of difficulties).

[R]ating pooled risks on their own experience is the soundest approach, because (i) it would assure that risks placed through the special facilities of the pool would pay a rate commensurate with their exposure to loss, in fairness both to pooled risks and to risks written outside the pool; (ii)

tion was to accept the underwriting decision of the voluntary market that a risk was different from voluntary business, and justifiably to be priced differently for that reason.<sup>192</sup>

A third approach, associated chiefly with the early Michigan program, avoided both of these alternatives. Michigan regulators shared the New York concern that the experience of the residual risks would be substantially worse than that for voluntary market risks. However, rather than forcing the body of residual risks to bear these costs, as in New York, or simply ignoring them, as in most of the other programs, Michigan chose to apply the voluntary market pricing formulas to residual risks and to treat the unrecognized costs of this approach as a subsidy to residual risks to be funded by recoupment through the next year's premiums for all property insurance written in the state.<sup>193</sup>

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it would assure the existence of a rate level that would permit the pool to underwrite liberally, in order to secure the principal social goal of making full coverage more widely available; and (iii) it would preserve for the benefit of properties insured through the pool the proceeds of condition charges applied to those properties after inspection.

*Id.* at 40.

192. To many, the New York rating arrangements appeared to signal a willingness to consign most urban fire and extended coverage insurance to a residual category, for experience rating would almost certainly increase the pressures on insurers to dump risks into the higher rates available in the pools. The New York Department recognized the argument, but concluded that "'dumping' cannot be totally eliminated, and is a price which must be paid for assuring an adequate fire insurance market." *Id.* at 42.
193. 1968 Mich. Pub. Acts, No. 262, § 2930(2): "Any deficits or profits from the operation of the pool shall be recognized in the ratemaking procedures and included in the rate for the types of insurance used as the basis for determining participation in the pool, in the same manner that expenses and premium taxes are recognized." The Michigan approach represented a consciously distinct departure from the attitude that had shaped most other state programs; it viewed the programs as a frank attempt to subsidize some residual insurance coverages and sought to avoid what Kimball, *Automobile Accident Compensation Systems: Objectives and Perspectives*, in R. KEETON, J. O'CONNELL & J. McCORD, *CRISIS IN CAR INSURANCE* 10, 23 (1968), has labeled "an unfortunate disposition to impose on insurers a duty to solve the problems of the market without providing adequate compensation." In the Michigan program, the "quiet conscription" of insurer surpluses, expertise, and distribution systems to a public purpose was to be compensated by the recoupment provision. The pool experience received immediate recognition without the averaging and weighting dilutions that would normally apply to increased losses; pool deficits were treated as a tax on all property insurance coverages. *See generally* National Underwriter (P & C), April 16, 1971, at 2, col. 1. The experiment was short-lived. In 1971, the recoupment provision was eliminated. 1971 Mich. Pub. Acts, No. 74, § 1, (codified as MICH. COMP. LAWS ANN. § 500.2930 (Supp. 1976)).

The most striking feature of these developments is how slight was the attention given by most states to the question of unrecognized costs. Except in a few states, the large questions of who was to pay for the increased coverage remained essentially unasked. Only in the self-rating states was the system structured to provide continuing review of what program experience could teach.<sup>194</sup> In most states the choices were buried in the rhetoric of industry responsibility. The result was a promiscuous pattern of redistribution, of uncertain size and directions.<sup>195</sup> As hope faded that these unrecognized costs would be small, the issue passed largely by default to HUD and the industry.<sup>196</sup>

The ethic that explained insurer participation also was felt in the treatment accorded questions of what risks would be written through the programs. The uneasy pretense that the reinsured riot hazard would constitute most of the environmental hazard, though useful to the Panel, HUD and the industry while the reinsurance bargain was being struck, was never very credible, and it became even less so when the HUD definition of environmental hazards

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194. See, e.g., *Insurance Advocate*, Jan. 3, 1970, at 5, col. 1; *Insurance Advocate*, Jan. 10, 1970, at 5, col. 1 (report of decision on New York pool's request for 26% increase; the Department permitted a smaller increase on the basis of unjustified expense components in the original request). Similar scripts were played out periodically in New York, with rates both increased and decreased with pool experience.

195. Early attempts by Whitman & Williams, *supra* note 188, to grapple with these questions accurately catalog the interactions between the environmental hazard prohibitions, condition and after charges, the civil disorder loading, and riot reinsurance premiums, but they assume a consciousness of purpose not found in the actual developments, and they offer only impressionistic indications of the magnitude of the redistributions involved.

Williams & Smith, *FAIR Plan Insureds: Occupancy and Location Characteristics and Experience*, 42 J. RISK & INS. 156 (1975), reports an attempt to determine program penetration of various occupancy and location groups and the loss experience of such groups for two policy years in the St. Paul-Minneapolis area. It is useful chiefly as an indictment of the failure of the programs to routinely code the information necessary to support such inquiries. See also H. SHAPIRO, *FIRE INSURANCE AND THE INNER CITY* 20 (Rand R-703-NSF 1971).

196. The FIA has repeatedly challenged industry figures purporting to show huge losses on FAIR plan business as predicated on "statutory" accounting methods rather than more representative "adjusted" methods. See generally *REPORTS ON FAIR PLAN OPERATIONS* 1971, *supra* note 68; *FULL INSURANCE AVAILABILITY*, *supra* note 15, at 28-29. Nevertheless, the FIA does not offer alternative statistics bearing directly on these questions. See *id.* at 5-7. Through September 1976, the industry claimed national operating losses (statutory underwriting losses less investment returns) attributable to FAIR plans in excess of \$265,000.00. *Insurance Advocate*, Apr. 16, 1977, at 1, col. 2.

was promulgated and riots diminished in importance in the underwriters' calculus. There were several problems in addition to the question of how to interpret the prohibition against underwriting on the basis of environmental hazards. One concerned setting a floor for insurability. The rubric that public policy does not permit insurance of the uninsurable might commend itself by its ring of common good sense, but on close examination "insurability" proved a slippery concept to try to capture in easily-applied underwriting guidelines.<sup>197</sup> In the automobile assigned risk plans, possession of a driver's license supplied a practical base line for eligibility; in property insurance, "insurable interest" was almost no floor at all, and compliance with building and housing codes, most agreed, was far too stringent a test. In the end, though the rhetoric was larded with suggestions that the programs were designed to provide coverage for properties that would be deemed insurable if mysteriously transported to a better neighborhood, the tacit solution was to duck the question of minimum standards; the subjective judgments of underwriters could not be formally liberalized in their own logic, and reliance would be placed on the appeals process and the fears of participating insurers to indicate if the eligibility criteria being applied were too rigorous or unduly lax.<sup>198</sup>

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197. For a discussion of the difficulties, see FIRE INSURANCE IN CONGESTED AREAS I, *supra* note 38, at 20 (emphasizing that the standard, however constructed, should "embody the concept that the condition of the risk, not the good faith of the applicant, is the determining factor").

Plans of operations for the programs tended to track the vague guidelines provided by 24 C.F.R. § 1905.7(c) (1976). Thus, for example, the Michigan standards were expressed in this fashion:

Reasonable underwriting standards . . . shall include, but not be limited to the following:

- (a) Physical condition of the property, such as its construction, heating, wiring, evidence of previous fires or general deterioration;
- (b) Its present use or housekeeping such as vacancy, overcrowding, storage of rubbish or flammable materials;
- (c) Violation of law or public policy which results in increased exposure to loss;
- (d) Substandard, unapproved, insufficient or otherwise unacceptable protective devices and equipment.

MICHIGAN BASIC PROPERTY INS. ASS'N, PLAN OF OPERATION (Nov. 1, 1971).

198. Of course, most insurance departments maintained complaint divisions which on occasion might intervene; more importantly, in theory at least, the programs typically provided for appeals to regulatory officials from adverse decisions by the programs. In fact, this source of oversight was little used. Program procedures usually called for intermediate appeals to specialized subcommittees of the programs, and then to the boards of governors, and only then to the insurance departments, so that only a small number of appeals ever reached regulatory officials. Moreover, most appeals dealt not with declinations

On questions of what coverages would be provided, there was less dispute. Federal involvement in housing policy and in efforts to stimulate small business development always has used credit as its basic tool, and fire and extended coverage insurance usually has been a prerequisite to the availability of federal money and guarantees; for some regulatory officials, the embarrassment that the insurance required for rehabilitation and redevelopment programs was not generally available largely defined the availability problem. The federal statute required that fire and extended coverage be provided, and HUD by rule extended the requirement to include vandalism and malicious mischief insurance. Demands for these coverages were specific and well defined; more subjective needs for the security that other insurance coverages could provide were less easily articulated and less frequently recognized. In fact, though the ascendancy of the antidiscrimination perspective of the programs would help feed pressures for their expansion to include homeowners, plate glass, bailee, and similar coverages, state regula-

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but with refusals to waive underwriting rules prescribing upper limits on program coverages or forbidding coverage of vacant buildings. The reasons for this subject matter appear to be several: outright declinations of residential and small commercial properties were relatively few; for such properties, the differences in cost between the programs and substandard markets might not warrant the expenses of an appeal; attacks on underwriting judgment applied to particular risks would have little chance of success. By contrast, underwriting rules governing upper limits of coverage were chiefly the product of a desire to spare the programs large single losses and of a preliminary decision that property owners of large values at one location would have sufficient market power to obtain insurance through their own efforts. Appeals could investigate the propriety of these judgments in particular cases, by focusing on market conditions and discernible features of the particular risk, and such applicants were likely to have the resources and know how to pursue the appeal. For an interesting example of this sort of interplay, see *In re Appeal of Buy-Rite Discount Centers* (New York Ins. Dep't, Aug. 14, 1970). There an applicant to the FAIR program sought coverage double the \$400,000 limit approved by the program. After noting that the inspection report showed no specific hazardous conditions, and the possible impact of a restriction of operations on the mostly minority employees of the discount store, the Department held:

Underwriting standards to be used by the Underwriting Association should not be the "normal" standards used in the open market but should be standards tailored to the types of risks which are not placeable through normal insurance channels, taking into consideration the commercial and social factors which necessitated the creation of the Underwriting Association in the first instance. In short, I find that the Underwriting Association's decision to refuse placement of the additional contents coverage to the applicant was arbitrary and should be overruled.

*Id.* at 3. There is little to indicate that the decision is a typical one.

tors more often were involved in disputes about the geographical restrictions and dollar limits of the programs than about the coverages offered. On these questions, as well, the ultimate shape taken by the programs usually reflected the pragmatic judgment that the programs should be primarily urban and residual in character.<sup>199</sup> That view matched insurer attitudes, but it would produce recurring conflicts with HUD.

The relation of the programs to the substandard market<sup>200</sup> posed a related question for state regulatory officials. The Panel recommended that FAIR plans provide for mandatory inspection of all potentially eligible property before a declination or an offer of coverage at more than standard rates, and that prospective insureds not be permitted to waive the right to an inspection in order to go directly into the substandard markets.<sup>201</sup> The Panel's reasons turned chiefly on abuses observed in the operations of urban areas plans; agents and brokers, lured by higher commissions available on risks placed in substandard markets, were thought often to have proceeded directly to substandard markets without first exploring alternatives available through the plans.<sup>202</sup> The Panel recognized that implementation of its proposal would help assure that the programs would cream the better risks insurable at program rates and thus seriously disrupt the substandard markets, but deemed that a necessary condition to the effectiveness of the programs.

In practice, the structure created under the federal enactment did not guarantee any substantial incursion into existing substandard markets. The federal statute's requirement that no declination or surcharge be attached to a risk without a prior inspection was binding only on those insurers participating in the state's programs; more importantly, there was no express federal prohibition of the use of waivers, and the pressures for waivers often grew intense. Initially, the shortage of trained inspectors and administrative personnel and the lack of established procedures resulted in giant backlogs in applications, and these delays in obtaining the requisite in-

199. By the mid-1970's, the pattern had stabilized. About two-thirds of the programs operated state-wide. Most excluded farm and manufacturing risks; two states, Rhode Island and Massachusetts, offered homeowners coverages. Seven coastal states had established beach and windstorm programs which operated separately from FAIR plans.

200. "Substandard insurers," as that term is used here, included insurers writing coverage at rates in excess of bureau rates under consent to rate laws, upward rate deviations, or surplus lines laws. For an examination of the role of such insurers, see S. WEESE, *NON-ADMITTED INSURANCE IN THE UNITED STATES* ch. 3 (1971).

201. PANEL REPORT, *supra* note 3, at 91-92.

202. *Id.* at 56-74.

insurance coverages had immediate and stultifying effects on mortgage transactions. In some instances, lenders and real estate agents with tie-in arrangements with the substandard markets aggravated the difficulties by delaying the search for insurance coverages to the last minute in order to use program delays as justification for bypassing the programs. Moreover, even in the absence of such delays or overreaching, some prospective insureds simply were willing to forego possible savings in the programs in order to avoid inspections.<sup>203</sup>

The most fundamental reason for waivers, however, was the inability of the state programs to provide the variety of coverages demanded by prospective insureds. Fire and extended coverage protection might be an adequate protective package for a homeowner, but even with vandalism and malicious mischief coverages the programs often did little for the owner of a restaurant or mercantile establishment unable to obtain replacement value or plate glass coverage through the programs and unable to place these and other allied coverages in the substandard markets unless they were accompanied by the basic fire and extended coverage components.

The states differed markedly in their reactions to this question. In Michigan, an unsuccessful attempt to prohibit by rule any recourse to the substandard markets without prior inspection was followed in 1971 by an absolute statutory prohibition such pre-inspection waivers.<sup>204</sup> In California, on the other hand, amendments to the FAIR program enabling legislation made clear that substandard markets were to be considered a part of the normal market to be exhausted before FAIR plan provisions were called into operation, with a vote of the agents in a geographical area to be relied upon to determine whether FAIR plan coverages would be made available in that area.<sup>205</sup> Most states occupied an uneasy position somewhere between these extremes.<sup>206</sup> Waivers usually were permitted, but their use was expected to be restricted to appropriate situations by the availability of binders and deemer provisions designed to

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203. In addition to residents' concerns for privacy and owners' less salutary worries that inspections might lead to reports of violations to housing authorities, this reluctance to submit to inspections may in part have been prompted by very real concerns that an inspection might have prompted repairs that would necessitate rent increases.

204. MICH. COMP. LAWS ANN. § 500.2912 (Supp. 1972).

205. "The purposes of this chapter are to do all of the following . . . (c) To encourage maximum use, in obtaining basic property insurance, of the normal insurance market provided by admitted insurers and licensed surplus lines brokers." CAL. INS. CODE § 10090 (West 1972).

206. Memo from J. Robert Hunter to George K. Bernstein (Oct. 26, 1971), printed in REPORTS ON FAIR PLAN OPERATIONS 1971, *supra* note 68.



limit the delays involved in obtaining coverage through the programs,<sup>207</sup> by publicity concerning the alternatives provided by the programs,<sup>208</sup> and by enforcement of existing anti-coercion and anti-tying prohibitions.<sup>209</sup> Whether these were adequate safeguards against abuses remained an open question. The answers depended both on one's attitudes toward what the programs should try to accomplish and on one's beliefs about the price consciousness of prospective insureds.

### 3. *Industry Hegemony and the Functional Orientation*

Thus, the state programs emerged as determinedly "private" programs, their slogans of voluntarism largely intact, with ample evidence that the programs would not import a significant regulatory involvement in the definition of underwriting and pricing practices in the voluntary market. That the boards of governors of the programs could expect to enjoy areas of substantial immunity from

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207. All state programs were required by HUD rule to include either a deemer provision or a binder provision. 24 C.F.R. § 1905.6 (1972). Deemer provisions typically provide that if coverage has not been provided within a certain period from the date inspection was requested, the risk will automatically be deemed insured pending the results of the inspection if the applicant has paid the "estimated" premium that will be required. Binder provisions permit the applicant to pay a "provisional" premium at the time inspection is requested and to receive temporary coverage pending the results of the inspection.

208. Public education programs are required both by the federal statute and HUD rule. 12 U.S.C. § 1749bbb-3(10) (1970); 24 C.F.R. § 1905.2 (d) (1976).

209. Although the Model Unfair Trade Practices Act expressly prohibits coercion "resulting in or tending to result in unreasonable restraint of, or monopoly in, the business of insurance," many states have adopted supplemental statutory provisions that prohibit individual lenders from requiring the purchase of insurance from a particular insurer, agent, or broker as a condition of a real estate loan. See, e.g., MICH. COMP. LAWS ANN. § 500.2077 (1967). In addition, the Justice Department can employ the McCarran Act exceptions for "boycott, coercion, and intimidation," 15 U.S.C. § 1011-15 (1970), to obtain consent decrees against tie-in sales of insurance by mortgage lenders. See, e.g., *United States v. Investors Diversified Serv.*, TRADE REG. REP. (CCH) ¶ 67799, 69574 (D. Minn. June 30, 1954). However, the coercive effect of the tie-in arrangement can be subtle and difficult to prove, so that insurance regulatory officials often have tried to limit the occasions for coercion by refusing to license as insurance agents those who will be handling real estate loan transactions, sometimes with indifferent success.

Despite these efforts, many in the insurance industry believe the practice remains widespread. For a general discussion of this subject, consult Kimball & Jackson, *The Regulation of Insurance Marketing*, 61 COLUM. L. REV. 141, 155-57 (1961).

public direction and control was reflected both in the importance the industry attached to struggles over the compositions of the boards and in the nature of the issues upon which their attentions tended to center. Where the structures of public accountability were weak, the boards were where the action would be. With the substance of public concerns often ill-defined and unrepresented, an orientation toward a sort of functional accountability to its constituents among participating elements of industry would provide the primary agenda of concerns out of which the boards would try to construct the programs.

a. *"Markets of Last Resort"*

More often than not, this agenda was dominated by two principal themes. The first was a corollary to the prevailing rationale for industry involvement in the programs. According to the controlling vision, the FAIR plans should be structured to assure that they would remain residual "markets of last resort," low visibility, private measures that would so occupy the field as to leave little room for governmental intervention. This impulse called for a delicate balancing. On the one hand, where possible, the programs should be resolutely "voluntary," with the provision of coverage explicitly a matter of industry grace applied to residual risks properly "incident to the business" of insurers operating in the private, voluntary market. Where the fact or illusion of voluntary action could not be maintained, at least the programs should be kept "private," with administration and control as much as possible in private hands. At the same time, however, although the programs should be prominent enough to pre-empt the threat of public alternatives, their scope should be strictly limited, in the sense that they should be restricted to what was "essential" according to the current political calculus; in no event should the programs imply any general industry responsibility for insuring availability nor any requirement that individual insurers deviate from their normal underwriting instincts in constructing their books of primary market business.

While the practical implications of this vision could prove hazy along the margins, at a minimum the dictates of voluntarism required that the industry stoutly resist efforts to place "public" representatives on the boards of governors. Such proposals seldom involved large numbers, and the resistance was prompted less by concerns about preserving industry majorities than by the determination to maintain the trappings of private, voluntary programs. After all, ran the industry arguments, it was industry surpluses and not public funds that were put at risk in the programs. More-

over, cost concerns and the desirability of keeping the programs in low profile necessitated that, wherever possible, the programs should operate only in urban areas and should provide only limited dollar amounts of a limited variety of coverages. Acquiescence in a private, voluntary character for the programs would help to assure a prominent place for those views in any consideration of proposals to extend the scope of the programs. Eventually, in a few states, public representatives were included on the boards, usually under statutory direction, but in all the programs the industry remained numerically and strategically in the dominant position.<sup>210</sup>

b. *"Incident to the Business"*

A second theme with pervasive implications for the development of the programs also surfaced in conflicts over the composition of the boards. The maneuvering that left substantial control of the programs in industry hands had not resolved the question of whose hands would actually be at the controls. Moreover, the convergence of interest that had permitted near-unanimity in the march on Washington for riot reinsurance and that could still be mustered for resistance to efforts to extend direct governmental supervision of the programs would dissipate quickly under the pressures of translating broad grants of responsibility into institutional arrangements acceptable to an industry of widely divergent needs and habits. The boards of governors would help to determine the impacts of the programs on participants, usually without the guidance of generally accepted indices of what would constitute a fair result.<sup>211</sup> In this circumstance, with real interests perceived to turn

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210. States with public representatives are: California, Delaware, Kansas, Kentucky, Massachusetts, Michigan, Missouri, New York, Ohio, Oregon, New Mexico, Pennsylvania, Rhode Island, Washington and Wisconsin. In several states the public representatives are non-voting, and centralization of important decision making in advisory committees, overlapping industry memberships on state boards, and the large role of the Property Insurance Plans Service Office made public representation even less suitable as a means of legitimating the authority wielded by the boards of governors.

211. Two excellent presentations of the argument that committing political questions to voluntary associations cannot be expected to eliminate the difficulties that attend coercion are M. OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1968); and T. LOWI, *supra* note 19. For historical treatments making the same point and emphasizing the claims it generates for public interventions to secure stability and predictability, see R. WIEBE, *BUSINESSMEN AND REFORM* (1962); J. WEINSTEIN, *THE CORPORATE IDEAL IN THE LIBERAL STATE* (1968); the hyperbolic G. KOLKO, *THE TRIUMPH OF CONSERVATISM* (1963). See also E. SCHATTSCHNEIDER, *POLITICS, PRESSURES AND THE TARIFF* 217-18 (1935) (discussing the "iron law of necessity" felt by

on the outcome, struggles over representation were a central feature of the organizational years of the programs, with battles for increased representation waged between different trade associations, direct writers versus American Agency companies, companies versus producers, agents versus brokers, domestic versus foreign insurers, and seemingly along most of many different planes on which divergencies of interest could appear. In the end, the result again was company dominance, with producers occasionally receiving a token role, usually only after legislative muscles had been flexed or regulatory support invoked.

The impacts to be adjusted could be substantial. The rating formulas adopted in most states promised to make program experience extremely unfavorable, and in numerous other ways the programs would intrude on established patterns of doing business and threaten dislocation of existing relationships among industry participants. Among the issues to be confronted were questions as fundamental as the participation formulas to be used to allocate the formal costs of the programs among participating insurers. On this matter, as on so many others, the federal statute had maintained a pregnant silence. Nevertheless, from an early stage there seems to have been general agreement that an appropriate allocation would tie an insurer's share of the costs of the residual program to the extent of its voluntary market writings within the state.

Of course, that concept could yield diverse interpretations. The problem surfaced most dramatically in the early days of the programs as disputes over whether commercial and habitational properties within a state should be handled in split programs or lumped in a single program; at stake were thought to be significant differences in the proportion of adverse financial experience that would be allocated to each insurer. For such questions there were no intuitively correct answers, and no amount of expertise and information could be expected to reduce the intractability of what were root questions of who was to be indulged and who denied. However useful the "incident to the business" rubric as constitutional standard<sup>212</sup> or as rationale for industry involvement, it clearly was

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pressure groups: "exaggerating the unanimity and determination of their membership" and "confess[ing] to internal divisions of interest only by accident or under compulsion").

212. In *California State Auto. Ass'n Inter-Ins. Bureau v. Maloney*, 341 U.S. 105 (1951), the Court upheld against constitutional attacks a California statute requiring insurer participation in an automobile assigned risk plan:

The case in its broadest reach is one in which the state requires in the public interest each member of a business to assume a pro rata share of a burden which modern conditions

inadequate as a measure of that involvement or of its allocation to component elements of the industry. Yet the debates were conducted in the rhetoric of the programs. The language of "responsibility" could be made to sanction almost any result, and insurers' arguments rarely went beyond broadly-framed attributions of relative responsibility for the availability problem. Insurers already committed by their voluntary market writings to a large volume of commercial risks could count them toward their quota of social responsibility and cite the unfairness of tying their participation in program results to such writings. The response for insurers lightly committed to such risks was equally clear: Insurers that had "profited from commercial writings over the years," that had "long picked the fruits of urban, commercial writings," should be treated as having a greater responsibility to support residual commercial risks than did the other companies.<sup>213</sup>

Related problems of similar difficulty concerned the role of producers placing risks in the programs. The insurer-dominated boards of governors often sought to set the commissions at markedly less than rates prevailing in the voluntary market. Producers resisted, usually without notable success. The companies could invoke two arguments for restricted commissions, one resting on allocational concerns, and one derived from the tenets of voluntarism: the responsibility embodied in the programs was an industry-wide responsibility, in which all the industry should share; and the lower commissions would act as a desirable discipline on producers to increase the likelihood that they would exhaust the voluntary market before sending risks to the programs. Eventually the commission schedules stabilized at about two-thirds of normal voluntary rates. From the agents' viewpoint, this result could be a powerful incen-

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have made incident to the business. . . . Here, as in the banking field, the power of the state is broad enough to take over the whole business, leaving no part for private enterprise. . . . The state may therefore hold its hand on condition that local needs be serviced by the business.

*Id.* at 109-10.

The notion may not be entirely without constitutional content. In *State Farm Mutual Ins. Co. v. Ingram*, 44 L.W. 2255 (N.C. Super. Nov. 7, 1975), the court held that a statute compelling a pro rata distribution of losses from a medical malpractice pool among general liability insurers, many of which had never written malpractice insurance, constituted a violation of equal protection and substantive due process guarantees of both federal and state constitutions.

213. See, e.g., *National Underwriter (F & C)*, Oct. 11, 1968, at 53, col. 2. Eventually seven states maintained split pools in which the extent of each insurer's participation was determined separately for commercial risks and for habitational risks.

tive for avoiding FAIR plans;<sup>214</sup> from the regulatory standpoint, it was a worrisome structural barrier to full utilization of the programs.

Other broad allocational questions centered on the treatment to be accorded substandard insurers in the programs,<sup>215</sup> the division of program business among adjustors,<sup>216</sup> and practical problems of matching program risks with servicing insurers experienced in handling business of that kind. Rationalizing the impacts of the programs was a continuing preoccupation that would drain energies away from other concerns, influence the way issues could be perceived, and ultimately force compromises with some of the apparent policy implications of the dictates of voluntarism.

These compromises were forced chiefly by variations on the fears classically associated with insurance pooling.<sup>217</sup> To insurers for whom sound underwriting and solid claims practices lay close to the heart of a successful insurance operation, the prospect of a residual market mechanism in which control of these defensive techniques would be shared with other insurers would appear only slightly less palatable than ceding these traditional prerogatives to governmental restrictions. In theory, of course, the loss of potential underwriting profit and investment income on premiums allowed to flow into the programs might be expected to discipline individual insurers to construct a realistic division between "distress" business and "normal" business, and thus to operate as an acceptable practical control on the possibility that other insurers would not act "responsibly" in selecting or servicing program business; in practice, insurers and producers schooled in competitive realities proved less than sanguine about the power of such market-based incentives to provide an acceptable line of demarcation between the voluntary market and the residual market.

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214. See, e.g., National Underwriter (F & C), June 13, 1969, at 33, col. 1 (statements by president of agents' association).

215. See notes 200-09 and accompanying text *supra*.

216. Eventually HUD was drawn into this fray. 24 C.F.R. § 1905.10 (1976) provides:

(a) No Plan or placement facility shall discriminate by providing for the primary use of services or any preferential treatment of any adjuster to the exclusion, detriment, or disadvantage of any other adjuster of equal or equivalent professional qualifications in any formal or informal arrangements of any insured losses under policies or contracts of insurance issued under the Plan.

217. See generally Haugh, *Insurance Pools*, in J. Long & D. Gregg, *supra* note 34, at 969. Most private pooling arrangements are structured to prevent adverse selection against the pool, often by requiring that members retain no business of the class pooled and place all such business in the pool. *Id.* at 970-71.

Nevertheless, substantial as these concerns might be, the instinct to refuse to trust underwriting decisions in the voluntary market to determine an equitable allocation of risks between the programs and the voluntary market was unlikely to result in industry support for significant inroads into traditional voluntary market underwriting prerogatives. The programs were efforts to avoid such restrictions, and direct limitations in the name of inter-insurer equity would be no more attractive than restrictions designed to serve other ends. Again, industry leaders turned to attempts to invest the rhetoric of individual insurer responsibility with some informal inhibiting effect, and at times encouraged state regulators to lend their powers of moral suasion to this cause. While these efforts probably helped to slow the flow of risks into the programs during the early days of large program backlogs, they offered little prospect of long term results, and in their suggestion that an objectively determinable line of demarcation could be drawn they were not without dangerous implications. Consequently, most insurer efforts to deal with these concerns centered on attempts to adjust the structures of the programs to impose indirect disciplinary influences on the way the troublesome questions of fairness to participants would be resolved in the programs.

### c. *Normalcy Versus Control*

Those issues in important measure were issues of equity born of fears that the conduct of some participants would unfairly burden other participants. In this setting, where uniformity of decision rather than any particular level of decision could seem the paramount value, efforts to minimize the differential impacts of the programs on participants often appeared as a tendency to centralize critical elements of the residual market operation better to enforce a consistent treatment of business handled by the mechanism. The inequities of the "luck of the draw" could be reduced by pooling experience and expenses instead of assigning risks.<sup>218</sup> The inequi-

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218. In actual operation, the "placement facility" contemplated by the PANEL REPORT, *supra* note 3, and the federal legislation soon gave way to the use of pooling arrangements. Distribution of risks to participants had worked under automobile assigned risk plans, but in those programs the coverages and limits typically were fixed at the minimum levels established in financial responsibility statutes; under the property insurance programs, the type of property, the value of the property, and the amount of coverage requested might vary greatly from one application to another. Nevertheless, initially some states adopted a "Model Uniform Basic Property Insurance Inspection and Placement Program" proposed by the Industry Property Insurance Liaison Committee. See II 1968 NAT'L A. INS. COMMISSIONERS PROC. 449.

ties produced by differing applications of the underwriting standards setting eligibility floors for the programs could be minimized by instituting centralized underwriting for the programs. The inequities introduced by divergent claims settlement practices of participating insurers could be curtailed by assigning these functions to the mechanism or contracting them out to a few large participants whose conduct could be monitored and whose substantial interests in the experience of the programs might be expected to exert a desirable restraining influence. That centralized operations might in the long run prove less costly than a program of diffused responsibilities offered reinforcement for the centripetal tendencies urging the mechanisms toward increased centralization of functions and dovetailed with HUD efforts to secure better monitoring and control of the programs.

Running counter to these tendencies were other impulses likely to produce resistance to centralization of mechanism functions. Some derived from the perceived dictates of voluntarism. Pooling and centralization evoked fear of a residual market mechanism with a corporeal existence distinct from voluntary market institutions, free of competition, indistinguishable in most relevant respects from governmental insurance programs. Other resistance tapped less speculative instincts. Where the status quo seemed to offer the only safe referent for what was "fair," keeping the impact of the programs residual was likely to mean preserving "normal" market mechanisms and established market positions. Thus, significant support could be mustered for the idea that programs should be

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It called for the placement facility to distribute an inspected risk to up to five participating insurers selected on a rotating basis, with each insurer retaining a \$5000 exposure, and with any excess receiving coverage in a reinsurance pool in which all insurers participated in the premiums and losses. The plans included a complicated system of criteria and limitations designed to match referred risks with insurers by line of property insurance and by geographical area served. They soon floundered in their own complexities and were replaced, at the instigation of participating insurers, by pooling arrangements. In Virginia, the companies sought and obtained an order from the State Corporation Commission requiring the change. *Virginia State Corp. Comm'n v. Arlington Mut. Fire Ins. Co.*, Case No. 18595 (Virginia State Corp. Comm'n, Oct. 24, 1968). See also *J. Com.*, Oct. 3, 1968, at 7, col. 3 (District of Columbia plan changed under pressure from Insurance Company of North America); *J. Com.*, Oct. 15, 1968, at 9, col. 1 (modification of Delaware program). The difficulties with assignment plans and the advantages of a pooling approach are ably presented in II 1968 NAT'L A. INS. COMMISSIONERS PROC. 449. See also *Hearings Before the Subcomm. on the District of Columbia*, 90th Cong., 2d Sess. 239 (1968) (later industry proposal). By early 1969, all programs were employing pools rather than assigned risk procedures.



structured to assure that the actual physical servicing of residual risks would be accomplished by existing voluntary marketing and claims adjustment institutions; that producers receive the normal voluntary market compensation for their efforts; that producers and insurers not be forced to handle risks of a kind they are unaccustomed to handling; that policies be issued by individual insurers rather than by the mechanism; that the prospective insured be allowed his choice of producer and insurer; that agents be appointed by insurers rather than by the mechanism; and so on through a long litany of resistance to differential impacts, alterations in traditional ways of doing business and creation of institutional arrangements which would appear to operate in non-normal ways.

If the tendency toward centralization of mechanism functions represented a search for control, these appeals to normalcy were in many respects an opposite centrifugal tendency where the preferred values were autonomy and the preservation of the familiar indicia of the private, voluntary insurance enterprise. The effect of the first tendency was to emphasize the difference between normal and residual markets; the effect of the second was to mask it.

In the continuing struggles over how the programs should be structured, the tension between these inclinations has been most plain in the ongoing debates about the respective merits of joint underwriting associations and reinsurance facilities.<sup>219</sup> The reinsurance facility approach offers the prospect of a low visibility mechanism and the maintenance of normal channels for placing residual risks, but at the cost that this very ease of access will subtly encourage an increased flow of risks into the facility. The joint underwriting association, on the other hand, appears to pose a more clear-cut underwriting issue to participating insurers, but at the cost of creating a separate mechanism engaged in far more than

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219. These approaches, and their many variations, have received wide coverage in the insurance trade press. An easily accessible survey of their central features is provided by a series of articles by J. Finley Lee and Roger Formisano: Lee & Formisano, *The North Carolina Plan: Blueprint for an Automobile Reinsurance Facility*, 1973 INS. L.J. 559; Lee & Formisano, *Automobile Insurance Markets: Developments in the Reinsurance Facility Technique*, 1975 INS. L.J. 9; Lee & Formisano, *Residual Markets in Automobile Insurance: The Service Center and the Joint Underwriting Association Approaches*, 1975 INS. L.J. 92; Lee & Formisano, *Residual Markets in Automobile Insurance: A Comparative Analysis*, 1975 INS. L.J. 143. See also Insurance Advocate, Oct. 2, 1973, at 16, col. 1 (reporting substance of debate over relative merits of "facility" and "joint underwriting association").

mere bookkeeping operations, with a personality and visibility that make identification of the mechanism with traditional insurance marketing institutions significantly more difficult.

This testing for structure continues, fueled by often markedly different attitudes toward the twin values of normalcy and control. However, nothing in this pattern has implied abandonment of the central industry rationale for the programs. To the extent the rhetoric of industry "responsibility" has had an identifiable content, the responsibility has been seen as an industry-wide responsibility to be executed through the programs and as implying no restrictions on underwriting decisions in the voluntary market. Depopulation of the programs appears always as a desirable result, but seldom as a program to be seriously implemented.<sup>220</sup> According to the controlling consciousness, the perceived compulsions to keep residual markets residual—both as a hedge against governmental displacement and as an effort to control competitive dislocations—are to be felt in the industry as pangs of social conscience and enlightened self interest. They are routinely invoked by a set of linguistic cues emphasizing the role of the industry in the programs and a structure of beliefs about how the programs should intersect with the voluntary market. As verbal symbols these cues could attract easy consensus, but as practical guides to what the programs do or should demand, they must be approached with caution. Clearly, from the industry vantage, despite the very real concerns that prompt them, their use has not meant industry endorsement of governmental constraints on underwriting decisions made in the voluntary market.

#### D. Dumping—The New Availability Problem

The ability of the industry to sustain this vision of the programs came under challenge almost from the outset. A variety of factors were at work that would tend to draw regulatory attention back to questions of the legitimacy of underwriting decisions made in the voluntary market and to encourage some regulators to hold out the prospect of objective standards against which to measure the validity of those decisions. Together they would suggest an alternative vision of the "availability problem" in which "dumping"

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220. Although there was considerable discussion of "take-out credits" and similar institutional arrangements designed to encourage depopulation of the programs, there is little evidence that these had much impact even in the few instances where they actually were implemented. See, e.g., N.Y. INS. LAW § 6541-a (McKinney Supp. 1976) (granting double credit against participation ratio for writing risk formerly written through FAIR program).

would assume the role of primary evil and the regulatory task would become to convert the rhetoric of nondiscrimination and insurer responsibility into workable procedures for actually policing the line between voluntary and involuntary markets.

Although its definition would evolve, the identification of "dumping" as a regulatory issue had begun even before the inception of the programs. In the period immediately after the 1967 riots, state regulatory officials had enjoyed notable successes in delaying mass cancellations of property insurance risks. Using a blend of private cajolery and public arm twisting, regulators in several of the most significantly affected states managed to enforce moratoria on cancellations pending development of the state programs. However, the statutory authority which they could invoke was weak or nonexistent, and these hialat efforts did not wear well once the programs began to operate. Many of the risks that flowed toward the programs were properties that previously had been insured in the voluntary market. Some left substandard or surplus lines insurers in attempts to qualify for lower rates through the programs; probably most, however, were risks that had been insured at manual rates, but which were cancelled or not renewed after the start of the programs. In many states the flow of business soon swamped FAIR plans beset by start-up confusions and the difficulties of physically inspecting each new risk. The regulatory response in most states was to encourage the adoption of improved binding procedures and other measures designed to smooth the entry of risks into the programs, and to add the regulatory voice to the industry chorus abjuring "dumping" and appealing for "responsible" underwriting decisions in the voluntary market.<sup>221</sup>

### 1. *The Royal Globe Decision*

Despite the aggressive tones in which the warnings were sometimes couched and the essentially unchecked flow of risks to the programs, only in New York did state regulators attempt directly to test the asserted prerogative of insurers to commit whatever risks they chose to the residual market. In what was widely—though probably unnecessarily—viewed as a watershed case for the entire question of the relation of the programs to voluntary market underwriting practices, the New York Insurance Department challenged the Royal Globe Companies' systematic program for reducing their voluntary market exposures. The Royal Globe Companies had been among the most heavily committed insurers in urban areas through-

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221. See, e.g., Kansas Ins. Dep't, Fire & Cas. Bull. No. 1969-1 (May 29, 1969).

out the country. After being backed down in efforts to cull their portfolios during the moratoria,<sup>222</sup> they greeted the advent of the New York program with a plan for cancelling and nonrenewing some but not all of their fire insurance coverage on commercial lines in the Harlem and Bedford-Stuyvesant areas. The New York Department responded with an administrative complaint charging the companies with violation of section 40(10) of the New York Insurance Law: "[No insurance company] shall make any distinction or discrimination between persons because of race, color, creed or national origin, as to premiums or rates charged for insurance policies or in any other matter whatsoever . . ."<sup>223</sup>

Royal Globe defended against the charge before the Department and in the press.<sup>224</sup> The curtailment program involved less than ten per cent of the companies' inner-city business and was designed to bring the Royal Globe Companies to a closer approximation of their proportionate share of urban liabilities: "[O]ur underwriting program, like that of other companies, is to avoid the voluntary writing of substandard risks in view of current underwriting and for which the pool facility is now available." The clear message of both the federal statute and the state program was that once the pool facility became available, cancellations and dumping were again the prerogative of insurers. The Department's charge that "the recognition of conflagration hazards in certain core areas smacks of racial prejudice" was labeled "patently absurd."<sup>225</sup>

After hearing, the Department held that the statute had been violated by each of 206 policy cancellations and imposed a fine of \$100 for each cancellation.<sup>226</sup> The decision recognized that state law contained no prohibition against underwriting decisions predicated on location, and explicitly found that the insurers "were motivated by underwriting and business reasons and not by racial hostility" in selecting the risks to be cancelled. Nevertheless, it concluded that the selection of areas in which the cancellations were to take place demonstrated that the race of inhabitants of the areas had been a factor in the selection, and that the decisions therefore involved a "racial distinction" in violation of the statute.

222. See, e.g., *National Underwriter* (F & C), July 19, 1968, at 5, col. 3 and at 15, col. 2; *National Underwriter* (F & C), Sept. 13, 1968, at 50, col. 1.

223. N.Y. INS. LAW § 40(10) (McKinney 1966). Of course, most states had even less statutory support for challenging such terminations.

224. See, e.g., *National Underwriter* (F & C), July 19, 1968, at 1, col. 3 (text of statement by president of Royal Globe over CBS TV news); *Wall St. J.*, July 11, 1968, at 22, col. 1; *National Underwriter* (F & C), Dec. 20, 1968, at 4, col. 1.

225. *Id.*

226. *In re British & Foreign Marine Ins. Co.* (N.Y. Ins. Dep't April 1, 1969).

The appellate division reversed in a memorandum decision, apparently on the ground that the record did not disclose that the cancellation action was "directed against any individual or group of individuals."<sup>227</sup> The court of appeals affirmed.<sup>228</sup> The majority opinion recited the details of the New York FAIR plan, noted the Superintendent's findings that the plan of action "was not based on any desire to discriminate," and concluded that no discriminatory effect had been shown:

In the first place, the petitioners continue to underwrite "personal line" fire insurance in Harlem and Bedford-Stuyvesant—which constitutes by far the greater part of their business—despite the fact that many other insurers have refused to do so. In the second place, their decision to cancel certain commercial insurance policies simply requires the owners of these policies to look to the statutory pool for insurance. This is precisely the reason that the pool was established. . . . The fact that the premium rates may be higher in the pool is not, of course, attributable to racial discrimination but, rather reflects the higher degree of risk undertaken by the members of the pool in insuring the particular property.<sup>229</sup>

The *Royal Globe* decision signaled a practical end to state regulatory efforts to influence voluntary market underwriting decisions. The New York experience had accentuated the paucity of statutory authority available to regulators, and doubtless many shared the basic industry position, apparently confirmed in the *Royal Globe* litigation, that provision of coverage through the residual programs was the most that should be demanded of insurers.<sup>230</sup>

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227. *British & Foreign Marine Ins. Co. v. Stewart*, 33 App. Div. 2d 1008, 307 N.Y.S.2d 749 (1970).

228. *British & Foreign Marine Ins. Co. v. Stewart*, 30 N.Y.2d 53, 281 N.E.2d 149, 330 N.Y.S.2d 340 (1972).

229. *Id.* at 59-60, 281 N.E.2d at 153, 330 N.Y.S.2d at 344. Judge Breitel, concurring, emphasized that commercial motivations would not insulate underwriting decisions with racially discriminatory impacts; the superintendent had simply failed to demonstrate a racially discriminatory impact: "The reason this case is particularly troublesome and the Superintendent has failed to sustain his determination is that it has been fundamental and legally acceptable in the insurance industry to classify risks on territorial bases if supported by actuarial data." *Id.* at 60-61, 281 N.E.2d at 153, 330 N.Y.S.2d at 345.

230. A similar occasion for broad inferences about the relation of the programs to voluntary market underwriting prerogatives to be derived from a much narrower holding was provided by *Fireman's Ins. Co. v. Washington*, 333 F. Supp. 951 (D.D.C. 1971). The city council of the District of Columbia in 1971 passed ordinances prohibiting declinations or nonrenewals "because of geographic area" and restricting automobile cancellations. *Fireman's* sought to have the two regulations declared illegal and their enforcement enjoined on the grounds that they exceeded the police powers granted to the city council by Con-

As inefficiencies were curtailed and backlogs of applications dried up, the "dumping problem" lost much of its urgency for state regulators.<sup>231</sup> Though pressures from producers and from company leaders sometimes still could prompt some to rail against dumping, these admonitions were understood by all concerned to be the preachments of old, with little to suggest that state regulators possessed either the will or the authority to convert the rhetoric into meaningful efforts to define and police a line of demarcation between voluntary and involuntary markets.

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gress. The court granted the insurer's motion for summary judgment on a finding that congressional enactment of the District of Columbia Insurance Placement Facility indicated congressional retention of police power on that subject:

The City Council's "geographic discrimination" regulation and the Placement Act both seek to regulate the same type of high risk coverage. The Council has determined that individual insurers may not, with limited exception, consider matters over which the insured has no control in making the determination of whether or not to insure. Prior to the regulation insurers did consider such factors. This expansion of risk is precisely what the Placement Act seeks to govern by apportioning such risk among all participating carriers. Regulation 71-8 would narrow the market which Congress intended all carriers to share.

*Id.* at 955. The court of appeals reversed in part, holding that the challenged regulations were within the concurrent police powers of the city council, but held:

The Placement Act deals with exactly the same problem of red lining as does Regulation 71-8. The Act's solution is an equitable distribution of the hazards posed by such high-risk properties among private insurers. By eliminating environmental hazards from the underwriting decision, Regulation 71-8 leaves the volume of such high risk properties insured by each company to be determined not by an equitable apportionment but by the vagaries of the geographic distribution of the company's applicants. The regulation thus results in a different distribution of risks than that intended by the Placement Act. Since Regulation 71-8 does interfere with Congress' solution to the red lining problem, it is preempted, hence invalid, as to basic property insurance.

*Fireman's Ins. Co. v. Washington*, 483 F.2d 1323, 1331 (D.C. Cir. 1973).

231. There were exceptions. Commissioner Denenberg of Pennsylvania took the strongest position:

The FAIR Plan has, in significant measure, lessened the kind of discrimination it was designed to end. But its very expansion has raised a question of whether it is fostering a new kind of discrimination.

If whole areas or classes of risk are automatically consigned to the plan, has the plan itself become an instrument of discrimination rather than its antidote? More and more, policyholders, agents and brokers say: "We want access to insurance companies like everyone else. We want the same services, the same facilities, and the same options. We do not want to be automatically consigned to the FAIR Plan. We want to be treated like first-class citizens."

National Underwriter (P & C), April 9, 1971, at 1, col. 1.

2. *The Annunzio Hearings and the Crime Insurance Precedent*

Nevertheless, the tensions that had surfaced in the *Royal Globe* litigation would not disappear. The majority opinion's casual assumption that the imposition of higher rates in the programs "reflects the higher degree of risk undertaken by members of the pool in insuring the particular property"<sup>232</sup> was not universally shared, and soon for some critics the availability problem in property insurance had "evolved into its functional equivalent—unpayably high rates"<sup>233</sup> charged by the programs.

This perspective was most forcefully presented by Representative Annunzio of Illinois. Application backlogs in the Chicago program, coupled with wide use of condition charges, a generously applied 100 per cent surcharge on plan business,<sup>234</sup> and a pattern of curtailment of voluntary market underwriting by insurers, fueled public criticism of the program and prompted congressional hearings<sup>235</sup> and introduction of legislation to require direct federal primary insurance whenever program rate quotations exceeded 175 per cent of manual.<sup>236</sup> The Illinois program was held up as a "classic case of incest, dominated by the industry from start to finish";<sup>237</sup> the high premiums charged by the program and continued "red-lining" and "dumping" by voluntary market insurers provided the prevailing themes for the hearings:

[I]f the underlying goal of the Federal Reinsurance Act was to eliminate the unavailability of "essential" property insurance, the Act as formulated has proven to be largely inadequate. The drafters of the Act failed to appreciate that insurance "availability" is inextricably entwined with the cost of insurance. . . . Unpayably high rates are as much a cause of insurance unavailability as are "redlining" and "blacklisting."<sup>238</sup>

232. *British & Foreign Marine Ins. Co. v. Stewart*, 30 N.Y.2d at 60, 281 N.E.2d at 153, 330 N.Y.S.2d at 345.

233. Comment, *The Central City Insurance Crisis: Experience Under the Urban Property Protection and Reinsurance Act of 1968*, 38 U. CHI. L. REV. 665, 673 (1971).

234. The special surcharge applied to almost all program risks in Illinois for "hazardous conditions not otherwise charged for" was declared a violation of federal prohibitions against environmental hazard charges, and abandoned, but not until it had sown considerable mischief. See generally *id.*; 1969 House Hearings, *supra* note 167.

235. 1969 House Hearings, *supra* note 167.

236. H.R. 13666, 91st Cong., 1st Sess. (1969); H.R. 19436, 91st Cong., 2d Sess., tit. VII (1970).

237. 1969 House Hearings, *supra* note 167, at 349 (statement by Representative Moorhead); see also National Underwriter (F & C), Apr. 25, 1969, at 2, col. 4 (report from industry vantage).

238. Comment, *supra* note 233, at 678. The cited article provides an accurate if uncritical reflection of the tone and content of the hearings;

Nevertheless, the Annunzio proposal was not enacted. Congress bolstered the investigatory powers of HUD by authorizing the Office of Review and Compliance,<sup>239</sup> and it required HUD to provide crime insurance coverages directly at an "affordable rate" in states in which HUD found a "critical market unavailability situation" for crime insurance coverages,<sup>240</sup> but it did not alter the delivery mechanisms nor the pricing standards applicable to the property coverages provided through the FAIR plans.

The crime insurance legislation departed from the FAIR plan model in two significant ways. First, it authorized direct federal provision of crime coverages where "a critical market unavailability situation for crime insurance exists in any State and has not been met through appropriate State action."<sup>241</sup> Second, the standard to be met by a state in order to forestall federal intervention was not simply that crime coverages be "available," but that they be "available at affordable rates."<sup>242</sup> The substantial willingness to breach these twin frontiers in the case of crime insurance but not for property insurance can be laid to a single dominant perception: from the outset there was general agreement that the crime insurance problem was far more one of extremely high costs, even at manual

a number of its factual assertions and conclusions are entitled to less weight.

239. See note 172 and accompanying text *supra*.

240. Pub. L. No. 91-609, 84 Stat. 1770 (1970) (codified primarily as 12 U.S.C. §§ 1749bbb-10a to -10d (1970)).

241. 12 U.S.C. § 1749bbb-10a (1970).

242. *Id.* "Affordable rates" are "defined" as follows:

In estimating the affordable rates for the various crime insurance coverages offered from time to time under this part, the Secretary shall consult with appropriate State insurance authorities and other knowledgeable persons and is authorized to take into consideration the nature and degree of the risks involved, the protective devices employed, the extent of anticipated losses, the prevailing rates for similar coverages in adjacent or comparable areas and territories, the economic importance of the various individual coverages and the type of property involved, and the relative abilities of the particular classes and types of insureds to pay the full estimated costs of such coverages. Nothing in this section shall be construed to prohibit or require either the adoption of uniform national rates or the periodic modifications of currently estimated affordable rates for any particular line or subline of coverage, class, State, territory, or risk on the basis of additional information or actual loss experience.

12 U.S.C. § 1749bbb-10c (1970). By regulation the FIA further defined the term in this fashion: "'Affordable rate' means such premium rate as the Secretary determines would permit the purchase of a specific type of insurance coverage by a reasonably prudent person in similar circumstances with due regard to the costs and benefits involved." 24 C.F.R. § 1930.1(a)(3) (1976).



rates, than of frictional unavailability of the sort diagnosed for the property insurance coverages.<sup>243</sup> The Panel had recognized that burglary and theft as well as fire and extended coverage insurances often were made a prerequisite to credit, and it had recommended that they be provided through FAIR plans.<sup>244</sup> That proposal got nowhere. To include the crime coverages in undifferentiated FAIR programs would have made their governing rationale untenable. The unrecognized costs of the property coverages could be spread widely across broad populations; the crime insurance base was much smaller. The subsidy required for some crime risks would have been too large and too apparent to allow a FAIR plan bargain involving crime coverages to be struck. In 1968 the crime insurance problem was deferred for further study.<sup>245</sup> The solution proposed by the FIA was enacted in the 1970 legislation.<sup>246</sup>

The industry displayed little reluctance to embrace the idea of a crime insurance program with the federal government as a risk bearer. The federal insurance was marketed through a limited number of private insurers who contracted with HUD to act as "servicing companies," and producers found their roles and their commissions little changed from conditions in the voluntary market. The chief dissents were registered by state regulatory officials. The objections went beyond the usual resistance to federal regulatory initiatives: federally written crime coverages would not be subject to state premium taxes;<sup>247</sup> moreover, the federal crime program held other dangers as well. In the FAIR plans,

both the voluntary and the involuntary markets are controlled by the same insurers. Therefore, there is no danger that the involuntary market will compete by attempting to write risks which are in fact acceptable to the voluntary market.

. . . .

The unfortunate aspect of the Federal crime insurance law is that it leaves the definition of the boundary between the voluntary and involuntary markets solely within the province of the Federal insurer. The administrators of the Federal program are empowered to determine what an "affordable rate" is, to define crime insurance so as to include or exclude certain coverages, and to decide whether insurance is being made available by private in-

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243. See, e.g., *Hearings on the Impact of Crime on Small Business Before the Senate Select Comm. on Small Business*, 90th Cong., 1st Sess. (1967); 1968 *House Hearings*, *supra* note 9, at 168 (Representative Moorhead making point that inspection of premises of crime insurance applicant unlikely to affect underwriting decision).

244. PANEL REPORT, *supra* note 3, at 89.

245. 12 U.S.C. § 1749bbb-15(a) (1) (1970).

246. FEDERAL INSURANCE ADMINISTRATION, REPORT ON AVAILABILITY OF CRIME INSURANCE AND SURETY BONDS IN URBAN AREAS (1970).

247. 12 U.S.C. § 1749bbb-20 (1970).

surers in any given state. Thus, the Federal insurer will enjoy a broad power to define the very problem which it is authorized to solve. The definition will clearly affect the boundaries of what is left over for the voluntary market. Instead of two markets, voluntary and involuntary, where the boundary between them is defined by the private insurers, we will have two markets, private and government, where the boundary between them is defined by the government insurer.<sup>248</sup>

The remedy, for regulators in states in which the FIA identified a crime insurance problem,<sup>249</sup> was to create a state program, but if the federal program were to be prevented the state program would be required to provide a subsidy. An NAIC committee approved a model bill in which the "anticipated deficits" of a state crime pool would be assessed against participating insurers,<sup>250</sup> but the proposal was opposed by all the major trade associations,<sup>251</sup> and only in Michigan, California, and Wisconsin did state crime pools provide a substitute for the federal program.<sup>252</sup>

Implicit in the industry acceptance of the federal program was a preference for subsidies provided through the National Insurance Development Fund from accumulated crime insurance premiums and riot reinsurance premiums, direct appropriations, and HUD borrowing authority. Apparently, there was some feeling that with

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248. National Underwriter (P & C); Mar. 12, 1971, at 28, col. 3 (Michigan Commissioner Van Hooser). In fact, the FIA made it clear that it would not peg federal crime rates to assure that federal provision of coverage would be limited to less desirable risks; the FIA wanted a mix of good and bad crime risks.

249. Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Kansas, Maryland, Massachusetts, Missouri, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Tennessee. 24 C.F.R. § 1931.1(b) (1976).

250. National Underwriter (P & C), Mar. 19, 1971, at 1, col. 4. See also I 1971 NAT'L A. INS. COMMISSIONERS PROC. 542-47.

251. I 1971 NAT'L A. INS. COMMISSIONERS PROC. 542-47. See also National Underwriter (F & C), Oct. 2, 1970, at 68, col. 1 (American Insurance Association announces willingness to support direct federal program with federal subsidy).

252. MICH. COMP. LAWS ANN. § 500.2901 (Supp. 1976) (adding crime coverages to FAIR plan); CAL. INS. CODE §§ 10101 to 10106 (1972) (state authorized to enter agreement to provide excess loss reimbursement up to \$500,000 for deficits in excess of a combined loss and expense ratio of 105%); WIS. STAT. ANN. § 619.01 (West Spec. Pamph. 1976) (authorizing additions to coverages subject to risk sharing plans, exercised by the Commissioner in 1971). New Jersey established a state program, but in 1972 it began to participate in the federal program when federal rates were reduced. National Underwriter (P & C), Nov. 10, 1972, at 50, col. 2. New York passed legislation establishing a state program with a state subsidy, but it was vetoed by Governor Rockefeller. Insurance Advocate, July 10, 1971, at 3, col. 1.

federal dollars at risk the crime program might not prove expansionist, and a willingness if necessary to abandon the crime lines to federal governmental programs.<sup>253</sup> In operation, the federal program grew very slowly, despite FIA reductions in rates and expansions of coverage. Program penetration remained low,<sup>254</sup> and in time there were suggestions that the program be revamped to eliminate the role of insurers and producers<sup>255</sup> or that it be terminated.<sup>256</sup>

### 3. *The FIA Reaction*

Although the Federal Insurance Administration opposed the Annunzio bills,<sup>257</sup> it soon was apparent that the FIA shared the proposals' attitude toward "dumping." The Federal Insurance Administrator labeled the *Royal Globe* decision "tragic,"<sup>258</sup> and in a progression of public statements and reports increasingly tended to summarize his agency's dissatisfactions with the programs as springing from "the inequitable treatment of FAIR Plan risks in

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253. Insurance Advocate, May 1, 1971, at 6, col. 1 (insurance company officer characterizing industry attitudes).

254. In the third year of operation, fewer than 25,000 policies were outstanding nationwide. For a discussion of the constraints on use of the federal program, see M. GREENE, GOVERNMENT AND PRIVATE INSURANCE 51-58 (NAII 1975).

255. National Underwriter (P & C), July 25, 1975, at 1, col. 2 (Representative Annunzio blaming foot-dragging by industry for low utilization).

256. National Underwriter (P & C), Jan. 9, 1976, at 1, col. 1 (suggestion by representative of FIA that inclusion of crime coverages in FAIR plans or in Full Insurance Availability programs might be better approach).

257. See 1970 House Hearings, *supra* note 171, at 350-51 (Federal Insurance Administrator Bernstein):

[The Annunzio bill] makes a significant departure from accepted principles of insurance ratemaking and even greater potential departure from the operations of the property insurance business as it has traditionally existed in this country. . . . [T]he States would thus be given the alternative of either subsidizing these FAIR plan losses from State or other sources, or else of submitting to a direct Federal property insurance program where rates exceed 175 percent of the normal rates.

Perhaps, in time, after demonstration of the inability of FAIR plans to solve the insurance availability problem, an approach like that of H.R. 13666 may be appropriate, but at this point in time, when our total FAIR plan experience is less than 2 years old, and when we have not yet exhausted all of the authority given us under the existing act to make FAIR plans more effective, we believe H.R. 13666 to be premature.

258. Insurance Advocate, Mar. 25, 1972, at 4, col. 3.

relation to voluntary market risks."<sup>259</sup> Once again, "dumping" was identified as the villain, but the theme struck by the FIA differed markedly from those that had most influenced industry development of the programs. Put simply, the FIA urged that residual property markets should be kept residual, not just as a hedge against potential governmental displacement, and not just to minimize and rationalize the impacts of the programs on the industry, but also because fairness to individual insureds demanded that the line between the voluntary market and the involuntary market be drawn "properly." The FIA diagnosis sounded a familiar note: "the inequity of subjecting more than a million FAIR plan insureds to second class treatment on the basis of subjective and undocumented underwriting judgments, forcing these insureds to pay more money for less coverage in the FAIR plan than for the same or full coverage in the voluntary market."<sup>260</sup>

The differences between voluntary and residual markets were real enough.<sup>261</sup> Even with automatic surcharges eliminated, condition charges meant that insureds with policies written through the programs usually would pay higher premiums than their counterparts in the voluntary market, even in states that did not purport to experience rate the residual business. Moreover, the "private" character of the programs and industry efforts to confine them to the "essential" guaranteed complaints about the narrow coverages, limited credit arrangements and other services available through the programs. To insureds denied admittance to the voluntary market, and to the producers, insurers, and regulators who fielded their complaints, "stigma" was a label that accurately captured the gravamen of the discontents: perceptions of second-class treatment engendered by hostile industry attitudes toward residual business, as mirrored in the inferior products and services offered through the programs.<sup>262</sup>

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259. Letter from George K. Bernstein, Federal Insurance Administrator, to Commissioners in FAIR Plan States (Jan. 28, 1972), at 4, *reprinted in* REPORTS ON FAIR PLAN OPERATIONS 1971, *supra* note 68 [hereinafter cited as Letter].

260. FULL INSURANCE AVAILABILITY, *supra* note 15, at 1. From an early date the HUD analysis was applied to automobile residual market problems as well as the property programs within the FIA's jurisdiction. For an explanation, see *id.* at 2 (the FIA "could not ignore the automobile insurance field where, under the assigned risk plans, the same practices prevail on an even greater scale").

261. For a summary of the differentials identified by the FIA, see Letter, *supra* note 259, at 6-7.

262. Significantly, the "stigma" often seems to be felt more keenly by the industry than by those to whom it attaches. Cf. R. KEETON & J. O'CONNELL, BASIC PROTECTION FOR THE TRAFFIC VICTIM 79 (1965) (dis-

From a perspective that would view the programs as at base instruments of public policy, with administrative tasks farmed out to the private insurance industry, the issues posed by such complaints might appear to be whether the price-coverage-service mix provided was adequate to serve the ends which had called the programs into being. But in an environment defined in large measure by the rhetoric of voluntarism and persistent appeals to normalcy, with only an inchoate and inarticulate sense of public quiescence to suggest when program performance should be deemed good enough, the question of what kind of treatment should be accorded risks forced to find coverage in a residual market mechanism was not kept distinct from the question of what sorts of underwriting decisions should be considered so antisocial as to warrant legal proscription. Almost inevitably, the coverage, price, and services provided in the normal market were adopted as the referent against which to measure the performance of residual market mechanisms; not surprisingly, in conventional thought and rhetoric—embraced and encouraged by the FIA—program problems came to be regarded as discrimination problems:

Assigned risk plans operate on the principle that there is a "voluntary" market and a residual or "involuntary" market, and that the two must be separated and *treated* differently. It is such separate treatment and handling—and inferior service—of the "involuntary" market that has caused assigned risk plans to be subject to severe criticisms.<sup>263</sup>

As the quotations suggest, for the FIA the prescription that this analysis seemed to require went well beyond bringing program prices, coverage and services to a standard supplied by the voluntary market. From concerns about the equity of differential treatment, depending on whether a risk is placed in the voluntary or the residual market, it was but a short conceptual leap to the conclusion that the preferred course might be to address root causes directly and to eliminate the separate treatment itself. By 1972, the FIA had publicly announced its conclusion that the FAIR plans were fundamentally unsound because "relegation to the FAIR Plan is usually based on the routine and frequently arbitrary judgment of a single underwriter".<sup>264</sup>

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cussing the way insurer attitudes toward automobile insurance assigned risks color insurer treatment of such risks); Handler & Hollingsworth, *Stigma, Privacy, and Other Attitudes of Welfare Recipients*, 22 STAN. L. REV. 1 (1969) (challenging on the basis of empirical data traditional assumptions about the "stigma" felt by welfare recipients).

263. Vanderbeek & Reinmuth, *The Reinsurance Facility: A New Approach to the Residual Auto Insurance Market Problem*, 22 DRAKE L. REV. 768, 769 (1973).

264. Letter, *supra* note 259, at 6.

[E]ven if the specific deficiencies in FAIR Plan operations can be rectified, we believe that the present approach to the handling of so-called residual risks in this country will continue to be unsatisfactory at best. . . . A totally different approach to the residual market is obviously required.

In this regard, we have already proposed, as you know, that all insurance companies licensed to do business in a particular State be required to write every insurable applicant for coverage at the same rate charged every other similar risk. If a particular risk possesses characteristics that, in the judgment of an underwriter, make it potentially unprofitable, the insurer could not refuse to write the applicant, but would be permitted to reinsure a portion of the risk above a specified retention with a single facility consisting of all insurers writing property insurance in the State. Under this approach, no insured would be relegated to different treatment than other similarly classified risks, and any losses would be shared equitably by all insurers on an appropriate basis. The whim of an underwriter could no longer subject a citizen to second-class insurance treatment.

. . . To avoid an excessive use of the facility, which could unduly burden particular insurers, the sharing ratio should not be based solely on voluntary premium writings but also on other objective criteria, including unutilized capacity and excessive reinsurance with the pool. This change could be coordinated with open-competition rating laws and with a requirement that rates be established on an insurer's total book of business, both pool and voluntary.

Such an approach would assure overall rate adequacy and with an adequate statistical system would ultimately lead to less pool utilization. To the extent that more broadly based coverages, classes, and territories were utilized, there would not only be a return to the original concept of insurance—spreading the risk—but there would also be an elimination of the duplication, waste, and stigma in current assigned-risk operations.<sup>265</sup>

Eventually, in late 1974, the FIA issued a full-blown brief for its proposal, christened the "Full Insurance Availability Plan,"<sup>266</sup> calling for its implementation by the states for "automobile insurance coverages as well as all other lines of property-casualty coverages which are not readily available at reasonable cost."<sup>267</sup>

The radical feature of the FIA proposal did not lie in the requirement that each insurer accept all applicants; the underwriting prerogative would not be withdrawn, but only shifted to allow a later determination of whether to cede the risk to a reinsurance facility. Instead, the radical import of the proposal lay in its propo-

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265. *Id.* at 7-8.

266. FULL INSURANCE AVAILABILITY, *supra* note 15.

267. Letter from George K. Bernstein, Federal Insurance Administrator, to James T. Lynn, Secretary, Department of Housing and Urban Development (Sept. 17, 1974), *reprinted in* FULL INSURANCE AVAILABILITY, *supra* note 15.

sition that all risks, whether or not ceded, should be written at the insurer's standard rates. This conclusion was said to be warranted, not because the risks ceded would not collectively produce an unsatisfactory loss ratio, nor because a subsidy of ceded risks by retained risks was thought socially desirable, but because of the FIA's fundamental distrust of the ability of rating and underwriting techniques as currently practiced to produce a "fair" line of demarcation between voluntary and residual markets.<sup>268</sup> The discrimination inherent in forcing into the programs risks which did not deserve to be there was to be relieved by obviating all distinctions in the treatment of insureds resulting from insurers' views of their desirability or lack of desirability.

Although the FIA proposal by its terms was animated by a demand for more accurate underwriting decisions in the voluntary market, it did little to document its assertion that large numbers of risks "improperly" were being shunted into the programs. Instead, by defining its concerns as "discriminatory" treatment of insureds and by emphasizing the undeniable truth that voluntary market underwriting practices in large measure remain subjective and unvalidated, the FIA was able to avoid the problems inherent in any effort to specify a vision of appropriately objective underwriting standards. In the FIA analysis, no attempt to police particular underwriting decisions need be made; the pressures generated by adverse experience of risks ceded to the reinsurance facility would reinforce heightened regulatory sensitivity to the need to avoid subjective rating and underwriting practices to force insurers to develop and adopt "objective and statistically supported classifications of risk."<sup>269</sup> Tautologically, rating and underwriting practices would become sufficiently "objective" when each insurer could "accept any risk at a rate appropriate to its exposure."<sup>270</sup> In the meantime, when reality falls somewhere between the FIA's neatly dichotomous "subjective and undocumented underwriting judgments" and "objective and statistically supported classifications of risk," whether an insurer chooses to reinsure a risk or not is of little moment in terms of primary FIA concerns, for "separate" treatment of risks has been eliminated whatever the insurer's decision.

Industry response to the FIA proposal was mixed. To some producer associations, the proposal was attractive because it appeared to promise both a guaranteed market and normalcy of operations in the placement of risks. However, it also prescribed arrangements

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268. FULL INSURANCE AVAILABILITY, *supra* note 15, at 5-8.

269. *Id.* at 12.

270. *Id.* at 7.

which most insurers perceived to be in conflict with the basic interests that had induced and shaped insurer participation in the programs. Thus, the proposal to charge each risk the insurer's standard rate regardless of whether the risk would be ceded to the faculty seemed likely to produce a scenario featuring competitive dislocations and an increased vulnerability to the threat of governmental displacement. With low-rate insurers unable to refuse to write applicants, risks could be expected to flow from the voluntary substandard market and from high-rate insurers to low-rate insurers. If the insurers' ceding limits were high, many of the new risks would be reinsured; if ceding thresholds were set low, there might be important implications for solvency, and low-rate insurers, for self-protection, could be expected to raise their rates. The resulting tendency toward uniformity of rates and rate classifications would be consistent with the FIA emphasis on "objectivity," but it involved the prospect of a loss of dynamism of competitive markets, and threatened to throw into bold relief the question of whether society needs numerous insurers and producers if they are to be providing essentially the same product.<sup>271</sup> In the view of the most influential insurer groups, FAIR plans and joint underwriting associations could be made to produce acceptable results without inviting the pernicious consequences of the FIA proposals.

#### IV. RECASTING THE DEBATE: SOME CAUTIONS AND A MODEST PRESCRIPTION

Here, at least for the moment, the debate has become stuck. The FIA continues to inveigh against "subjective" underwriting and rating practices and to proselytize for its full insurance availability program,<sup>272</sup> but with only minimal success as measured by legislative acceptance of its prescriptions in the states.<sup>273</sup> Insurers have

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271. Insurance Advocate, Oct. 27, 1973, at 16, col. 1 (summarizing objections to FIA proposals).

272. See, e.g., National Underwriter (P & C), May 21, 1976, at 9, col. 1.

273. Apparently no state has adopted the FIA proposals for property insurance, but in North Carolina, which has a long history of large and troublesome automobile assigned risk populations, a reinsurance facility for automobile liability insurance has been prescribed by statute. See N.C. GEN. STAT. §§ 58-248.26, 58-248.40 (Cum. Supp. 1976). This development has been accompanied by attempts by state regulatory officials to require a "merit rating" classification scheme based solely on individual driving records. For a summary account of the running battle conducted in the press and in the courts see Flanigan & Johnson, "Merit Rating" for Automobile Liability Insurance, 1974 INS. L.J. 425. See also MASS. GEN. LAWS ANN. ch. 175, § 113H (West Supp. 1976); S.C. CODE §§ 37-591.11 to 37-591.16 (Supp. 1976). Cf. National Underwriter (P & C), Apr. 1, 1977, at 1, col. 1 (Michigan report recommending FIA-style legislation for automobile and homeowners coverages).



responded with proposals to adjust existing residual market mechanisms and with a full-blown brief arguing the necessity of untrammelled freedom to engage in risk classification and selection,<sup>274</sup> but seem not to have been able to counter the attractiveness and definitional potency of the FIA's anti-discrimination diagnosis. In what is apparently a familiar pattern for such disputes,<sup>275</sup> the debate increasingly has been conducted on two planes. The first, so far dominated by the industry perspectives, opposes conflicting predictions about the technical, short-run implications of implementing the FIA proposal rather than some form of pool or joint underwriting association.<sup>276</sup> The second, of more concern to us here, questions the adequacy of the FIA's "discrimination" diagnosis of availability problems as summarization of the interests and values involved and as guide to future moves in public policy. In this latter debate, if only because "the metaphorical view that is officially disseminated usually enjoys a significant advantage,"<sup>277</sup> insurer efforts to construct and gain acceptance for an alternative conception of the availability problem could be expected to encounter substantial difficulties. They have.

Thus, although the history recounted in this article would seem to suggest that the once-amiable fiction that the programs are private assumptions of responsibility for providing coverages for residual risks "incident to" insurers' normal business has outlived its usefulness to the industry, no alternative rationale has been created to replace it. That is not to denigrate the continuing industry instinct to try to preserve the "private" image of residual market mechanisms; doubtless it remains true that a "private" character helps to insulate an enterprise from detailed public scrutiny and that differentials perceived to be the product of the market still are tolerated far more readily than similar differentials in the provision of "public" services by "public" agencies.<sup>278</sup> The repeated assertions of industry responsibility have had important effects of this intended variety. Indeed, in a sense they have succeeded too well. Years of insistence that availability problems were private problems, to be handled by the industry, may have

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274. STANFORD RESEARCH INSTITUTE, *supra* note 15.

275. See, e.g., Herzog, *Patterns of Controversy*, 13 PUB. OPINION Q. 39 (1949) (reporting a taxonomy of "characteristic differences in the tone and slant of answers given by those in favor of and those opposed to the program or policy under inquiry"); R. LANE, *THE REGULATION OF BUSINESSMEN* 42, 75-88 (1954).

276. See note 219 and accompanying text *supra*.

277. M. EDELMAN, *POLITICS AS SYMBOLIC ACTION* 72 (1971).

278. For a powerful treatment of this familiar theme, see Reich, *The Law of the Planned Society*, 75 YALE L.J. 1227 (1966).

served to deflect and defer direct governmental intervention in the underwriting process, but as availability has become an inescapably "public" concern, as it has in the last decade, the identification of the residual market mechanisms with the normal insurance industry has facilitated an analysis that fixes blame on the insurance industry for differential treatment of residual risks. It also has helped to embed in the public imagination assumptions that make it extremely difficult for insurers to reverse their traditional stance in order to argue that residual market programs should be viewed as public efforts to deal with the normal, acceptable fallout of voluntary market underwriting decisions. As a consequence, the debate is being conducted on the FIA's ground: availability problems remain "regulatory" problems freighted with the range of channeling attitudes implicit in that conception; substantively, availability problems remain discrimination problems, making existing industry practices appear especially vulnerable because matched against the FIA vision of objectivity, accuracy and precision.

#### A. Limitations of the Anti-discrimination Sentiment

The rhetorical skill with which the FIA has packaged its proposal has much to do with the continued hegemony of the anti-discrimination sentiment as organizing conception for perceptions of availability problems. By merging its condemnation of "subjective" and "unvalidated" underwriting and rating judgments with the "no distinctions" prescriptions of its Full Insurance Availability proposals, the FIA suggests that an insurer underwriting or rating decision is proper only if it "carved the [property insurance] universe at a natural joint,"<sup>279</sup> without undertaking to specify the standards by which to determine acceptable incongruencies or which rating and underwriting indicators should be proscribed. The FIA's decision to treat imprecision in rating and underwriting rather than its adverse impacts as the determinative evil has made its prescription equally applicable in theory to all lines and classifications of insurance, and thus has allowed the FIA to avoid the difficulties implicit in trying to assess when negative underwriting decisions become a "problem" requiring regulatory intervention. Perhaps most significantly, by framing its proposals as imperatives of traditional notions of rating equity and precision, the FIA has been able to call for internal subsidization of residual risks—

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279. The phrase is drawn from Tussman & Ten Broek, *The Equal Protection of the Laws*, 37 CALIF. L. REV. 341, 346 (1949), where the bootless character of such an inquiry is made plain.

"temporary," of course—in the name of the ordinary regulatory goals of effective and accurate cost-based pricing of property insurance coverages.

The anomalies implicit in this situation—a perceived demand for accurate and particularized treatment of individual risks results in a prescription that insurers ignore observed bases for differentiation and write all at the same rate, and a rhetoric of anti-discrimination adopted to avoid governmental interference with underwriting prerogatives becomes the vehicle by which limitation of underwriting freedoms is counseled—are at once a measure of the rhetorical resources of the FIA proposal and an indication of its analytical limitations. As argument, the FIA use of a simple slogan decrying inaccuracy and imprecision appears to succeed as a definition of availability problems that allows the FIA "to conceal the points of political conflict in favor of abstract principles of political resolution"<sup>280</sup> and that obscures the contradictions between the principle and the expedient accommodations that must be made to apply it. As serious guide to the interests and issues involved in the availability problem and how public policy should regard them, it is inadequate for those same reasons.

Thus, one warning that should be attached to the FIA's packaging of the anti-discrimination sentiment is that it tends to divert attention from the nature of the principle being asserted and thereby encourages the disposition to consign disagreements about it to familiar but only partially apt categories of contention. For instance, there is a temptation to dismiss the current debate as simply another dispute over how to make the trade-offs, implicit in any classification scheme, between "equity," "efficiency," and "incentives" on the one hand, and "equality," "spread," and "broad averaging" on the other. Some commentators have seen in the FAIR plans and in the FIA proposals the emergence of a shift away from traditional industry and regulatory assumptions about how broadly insured losses should be spread. As Professor Long views the long-term trend, heretofore in most insurance lines

the tendency clearly has been toward progressive refinement of insurance rates to match anticipated losses of a particular insured for a particular period. This refinement has been viewed as progress, as improvement, as an approach to equity, and as commendable. However, over the long-range future the trend may be reversed. The public may decide, at least for certain types of insurance, that the losses should be spread over relatively large groups without the usual attention to actuarial finesse.<sup>281</sup>

280. Bennett, *supra* note 11, at 38.

281. J. LONG, *supra* note 108, at 110. To some observers, the advent of the FAIR programs seemed to signal the beginnings of a movement to-

As a description of some of the immediate effects of the property programs and of the FIA formula, this statement clearly is accurate. So also, from this limited perspective, are similar conclusions that label these developments as another example of "taxation by regulation"—of an internal subsidy clothed in the rhetoric of equity.<sup>282</sup>

Nevertheless, it is important to recognize that although the FIA's proposal imports these consequences, its argument does not. The animating values articulated in the FIA diagnosis are precision, not spread, and correspondence between cost and price, not purposive deviations from cost-based rates in the name of affordability. Of course, at times both sides of the debate have found it useful to attempt to frame the issues in the more familiar language of subsidy and spread: an important part of the rhetorical strategy of both the FIA and the industry has been to attempt to saddle the other with the charge that its position promotes an unwarranted subsidy of bad risks by good risks; doubtless, too, insurers would prefer that criticisms of current practices be understood as claims that classifications cut too broadly rather than that they are inaccurate. But while issues of how broadly classifica-

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ward a "community rating" philosophy for property insurance in which an increase in premiums paid by low risk and low expense insureds would offset a decrease in the premiums to be charged high risk and high expense properties. See, e.g., J. Com., Aug. 29, 1969, at 8, col. 1 (reporting speech by Herbert Denenberg). In several senses the analogy was apt. Community rating in the health insurances also was a product of fear of governmental displacement of private institutions, and it too developed crescively and without any clear vision of how health care coverages should be priced. But see D. MACINTYRE, *VOLUNTARY HEALTH INSURANCE AND RATEMAKING* 18-49 (1962). On the other hand, at least as yet, in property insurance there have not emerged the highly crystalized ethical and moral arguments that have influenced "community rating" in the health insurances. See especially *id.* at 252-258. J. LONG, *supra* note 108, at 113-117, sees some evidence of a nascent sentiment of this sort in the FAIR programs, but he draws his examples more from the Panel Report's advocacy of consciously constructed public subsidies than from the shape actually assumed by the program, and his perceptions in many ways do not mesh well with the tone of the FIA analysis.

282. See generally Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGT. SCI. 22 (1971); Stigler, *Director's Law of Public Income Redistribution*, 13 J.L. & ECON. 1 (1970); Hilton, *The Basic Behavior of Regulatory Commissions*, 62 AM. ECON. REV. 47, 50 (1972). The line of argument, though its details differ, draws from the same instincts that have fueled arguments for entry restrictions in the so-called "natural monopoly" markets as a means of avoiding cream-skimming by new entrants that will inhibit the abilities of existing institutions to provide needed but unprofitable services. In property insurance, with multiple providers, the restrictions suggested by the FIA necessarily take the form of an imposed uniformity and pooling of results.

tions should be structured and whether it is appropriate to make purposive redistributions through the insurance rate structure are significant elements of the larger availability problem and thus pose important regulatory issues,<sup>283</sup> these are not the primary areas of difference between the FIA and insurers. Instead, both profess to embrace precision of cost-based pricing as a primary goal. Where the FIA differs from the traditional view held by insurers and many state regulatory officials is in its attitude toward how this goal should be pursued in the face of the major conceptual and practical barriers that stand in the way of perfect discrimination. What in the traditional view is the exercise of underwriting judgment in the search for greater refinement and thus greater equity is in the popular view articulated and fostered by the FIA analysis an infection of subjectivity that prevents the achievement of accurate cost-based pricing. For this state of affairs insurers counsel research, judgment, and responsibility; the FIA finds its answer in the aphorism that makes risk spreading "the original

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283. See generally J. LONG, *supra* note 108; Pauly, *The Welfare Economics of Community Rating*, 37 J. RISK & INS. 407 (1970); Long, *Insurance Subsidies and Welfare Economics*, 39 J. RISK & INS. 341 (1972). Cf. PANEL HEARINGS, *supra* note 3, at 52 (Commissioner Roddis of California discussing difficulties and dangers of subsidy efforts through rate structure adjustments).

Most of the explicit work on these questions in property insurance has been prompted by the failure of private insurance mechanisms to provide the so-called "disaster" coverages—earthquake, flood, hurricane, and windstorm—in the localized areas in which they are most needed. See generally D. DACY & H. KUNREUTHER, *THE ECONOMICS OF NATURAL DISASTERS; IMPLICATIONS FOR FEDERAL POLICY* 244 (1969). Proposals usually involve a mandatory combination of coverages for these perils in standard property insurance policies in an attempt to provide spread across both perils and geographic areas. Professor Anderson has provided the most easily accessible consideration of recent proposals and their implications. Anderson, *An Analysis of the Federal Catastrophe Insurance Program*, 27 CPCU ANNALS 213 (1974); Anderson, *Development of the Principal Elements of a Comprehensive Catastrophe Insurance System*, 28 CPCU ANNALS (1975); Anderson, *All Risks Rating Within a Catastrophe Insurance System*, 43 J. RISK & INS. 629 (1976). See also Kunreuther, *The Case for Comprehensive Disaster Insurance*, 11 J.L. & ECON. 133 (1968). Most such discussions assume a rough equivalence of the exposures added by "all-risk" packaging, with hurricanes in Louisiana balancing tornadoes in Kansas and earthquakes in California. For a time, the NAIC flirted with the idea of recommending model implementing "all-risk" legislation, but the proposals encountered strong insurer opposition and were never close to adoption. See generally II 1972 NAT'L A. INS. COMMISSIONERS PROC. 511-15; I 1974 NAT'L A. INS. COMMISSIONERS PROC. 550-64. Cf. Sullivan, *Possible Industry Approaches to Catastrophe Coverages*, 28 CPCU ANNALS 26 (1975) (surveying various industry attitudes toward "all-risk" proposals).

concept of insurance,"<sup>284</sup> and urges that until rating inadequacies can be corrected, greater "spread" is to be preferred to "subjective" attempts to make distinctions among risks on bases not recognized in the rating plans being employed.

Thus, to the extent that the current debate is characterized as featuring disputes about appropriate degrees of spread or the propriety of purposive deviations from efforts to make property insurance prices proportional to expected costs, the most significant aspect of the disagreements between the FIA and the insurers is being missed. That area of difference continues to involve the underwriting prerogative and whether and how it should be constrained. The FIA proposal continues to make the market guarantee an "industry" responsibility. It avoids direct interdiction of an individual insurer's freedom to decide for itself whether to add a particular risk to its own portfolio, but hides that decision from insureds and the public by forcing it to occur behind the scenes as a decision to reinsure. The FIA prescription does not alter the FAIR plan result that makes insurers collectively assume the unwanted risks, nor does it change the nature of the gamesmanship involved for insurers concerned about how the adverse experience will be allocated.<sup>285</sup> The real lines of division between the FIA and the insurers continue to be drawn over whether, and when, and under what terms industry surpluses and administrative structures should be conscripted to provide coverage to unwanted risks. Thus, though the rhetoric is little changed, the rationale for imposing an industry-wide obligation to assume unwanted property insurance risks has moved a long way since the urban areas plans: from a "voluntary" acceptance of corporate responsibility to not withdraw from core areas in the face of urban crisis; to a prohibition of underwriting against certain property insurance coverages on the basis of area alone; to a generalized anti-discrimination norm indicting the imprecision of property insurance rating structures.

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284. Letter, *supra* note 259, at 8. The FIA arguments, drawing their examples chiefly from automobile insurance, repeatedly have included attacks on the industry's "passion for overclassification" and calls for a "return to the basic insurance principle of spreading the risk." See, e.g., Bernstein, *The Bernstein Proposals* in PROCEEDINGS OF THE NAI 18TH ANNUAL WORKSHOP 199, 204 (1972).

285. See generally FULL INSURANCE AVAILABILITY, *supra* note 15, at 12-15. The FIA proposes a sharing formula designed to penalize insurers "ceding more than their fair share" to the reinsurance facility, *id.* at 14, by tying participation to relative growth or reductions in retained premiums written as compared to a five year base period. If, nonetheless, "abuse of the Exchange does occur, the legislation should provide for the governing committee . . . and for the State regulator to take appropriate action." *Id.* at 15.

In a sense, the rhetoric has become the reality; the "problem" has been limited and amended by the labels used to describe it. Though the attractions of the anti-discrimination label derive in large part from the variety of concerns it can seem to express, as translated in the FIA prescription its focus is narrow and one dimensional, with a tendency to confine the debate to the question of whether insurers can defend the subjectivity, rules of thumb, and "judgment" that characterize existing market practices.

Still another caution concerns the inadequacies of the anti-discrimination sentiment itself. The accuracy and objectivity that the FIA offers as the corrective for the imprecision and subjectivity it indicts for causing availability problems cannot be expected to function as standards against which to measure industry performance and the need for regulatory initiatives. They are sentiments, not standards, and they share the limitations that Edelman has termed "[t]he fundamentally insatiable character of political goals."<sup>286</sup> Accuracy in this context has no customary defining ethos, and the FIA does not attempt to supply one. "Equity will support anything,"<sup>287</sup> W. Arthur Lewis has told us; so also with the FIA's anti-discrimination sentiment. The practical consequences of this situation are several.

One involves the difficulties of determining the circumstances in which programs to ensure availability will be required. The FIA's selection of rating and underwriting imprecision as the determinative vice, rather than unavailability and its consequences, makes the FIA's prescription by its own logic equally applicable to all lines, amounts, classifications and locations of insurance without regard to the nature or the magnitude of the impacts of the negative underwriting decision. The FIA recognized this feature of its proposal, and attempted to make it a virtue:

Although the Full Insurance Availability system could be applicable both to personal lines of insurance and to small commercial lines, we do not attempt to define or limit the lines of personal and small commercial coverage that should be included in the mandate. That is the responsibility of the individual States, which are best able to evaluate their needs and the appropriate solutions.<sup>288</sup>

286. M. EDELMANN, *THE SYMBOLIC USES OF POLITICS* 190 (1964).

287. W. LEWIS, *OVERHEAD COSTS* 47 (1949).

288. *FULL INSURANCE AVAILABILITY*, *supra* note 15, at 9. *But see id.* at 74-75:

The lines of insurance to be covered by the mandate should include, as a minimum, those lines which are considered essential on the basis of current societal and business requirements. . . . Excepted from the mandate, however, should be those lines of insurance, such as flood insurance, where private industry is unable to provide broad coverage at unsubsidized rates without government assistance.

Of course, any decision by a state to limit the programs would, in terms of the anti-discrimination rationale, render the state vulnerable to the charge that it is engaged in official redlining. The charge is not an unfamiliar one to state regulators faced with complaints about the geographical limits of existing programs, their coverage limits, or their failure to offer homeowners and other package coverages. Heretofore rejoinders have been able to draw upon the patent character of the programs as limited responses to one facet of the urban crisis; debates that focus on the pragmatic judgments involved in defining a minimum of "essential" property insurance coverages doubtless are ad hoc and expedient, but at least they are likely to be in touch with the appropriate issues and interests. The FIA rationale, by contrast, would appear to legitimate and demand a limitless series of interventions.

Even more fundamentally, the FIA analysis purports to be an indictment of imprecision in current property insurance rating and underwriting practices, but its articulation of the anti-discrimination sentiment provides no stopping points for evaluating rating and underwriting practices actually employed in the voluntary market.<sup>289</sup> For reasons canvassed earlier in this article, complete particularization is an ephemeral notion impossible to achieve in practice, and its claim to status as a regulatory value is not unequivocal. Translated into terms of the possible, the FIA anti-discrimination sentiment becomes an ambition that rating and underwriting indicators be made to demonstrate an acceptably high correlation with the inference sought, still with no intrinsic guides to what should be deemed acceptable congruence or to what the congruence should relate. Thus, while the anti-discrimination sentiment must import some idea of eliminating what Professor Tribe has called "readily unprovable generalizations,"<sup>290</sup> the questions that it poses cannot really be reduced much beyond whether the inevitable decision rules will be "rules of thumb" in the pejorative FIA sense, or

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289. See, e.g., *FULL INSURANCE AVAILABILITY*, *supra* note 15, at 12:

The insurance industry would be required to utilize objective and statistically supported classifications of risk and to compile credible statistical data consistent with basic principles of insurance.

... Complete elimination of rate classifications is not necessary, desirable or contemplated, . . . but present abuses cannot be adequately corrected until classifications are required to be statistically supported and the number of classes is reduced substantially.

290. Tribe, *Childhood, Suspect Classifications, and Conclusive Presumptions: Three Linked Riddles*, 39 *LAW & CONTEMP. PROBS.* 8, 11 (1975).



corporate decision rules acceptably predicated on experience, research and sound judgment.<sup>291</sup>

Moreover, in any inquiry into degree of congruence, one must consider not only the indicator but also the inference the indicator is thought to suggest. Is the congruence to be between the rating indicator and the "attractiveness" of the risk to an insurer? And its "riskiness"? Or "riskiness about which the prospective insured could do something"? If the last or even the second of these alternatives is thought appropriate, then the inquiry is not solely into

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291. The lessons learned in the recent excursion of constitutional law into "conclusive presumption" analysis may be relevant here. At the least, this experience would appear to indicate the wisdom of fixing attention on the broader question of the reasonableness of the relationship between the classification base and the inference it is supposed to support rather than solely upon the degree to which the classification indicator provides particularized accuracy in individual cases. See generally Note, *Irrebuttable Presumptions: An Illusory Analysis*, 27 STAN. L. REV. 449 (1975); Note, *The Irrebuttable Presumption Doctrine in the Supreme Court*, 87 HARV. L. REV. 1534 (1975); Note, *The Conclusive Presumption Doctrine: Equal Process or Due Protection*, 72 MICH. L. REV. 800 (1974).

Admittedly, at one level the chief consequence of this choice of focus is to admit to the governing calculus considerations of administrative feasibility and costs of further particularization. See, e.g., I A. KAHN, *supra* note 18, ch. 7. More significantly, however, at some level decision rules will persist because the more precise questions they avoid simply are not answerable in the context in which they arise: conclusions for predictive exercises inevitably are applicable only across the populations involved and not for individual members of the population. Thus, when Professor Long predicts that "[c]ybernetics will make rate making a science," he is not envisioning the millennial textbook extreme of completely particularized rate making; nevertheless, the demand "to be treated as an individual rather than as a statistic or as a member of a group—particularly of a group the individual did not knowingly choose to join," Tribe, *supra* note 290, at 10, is as persistent—and as intractable—in insurance as elsewhere. For a highly speculative suggestion of how the industry might react to such claims, see STANFORD RESEARCH INSTITUTE, *supra* note 15, at 108: "The accuracy and sense of fairness in risk assessment could be enhanced by providing a course of appeal for individuals—such as a personalized rating service." Cf. AM. INS. ASS'N PROC. 85-86 (1976) (actuary indicating conceptual and practical difficulties of appeals program).

Of course, the law currently is wrestling with such questions in a variety of settings. For a full development of the arguments that swirl around the problems of "false positives" in predictive decision-making and, by contrast, a useful sense of proportion concerning the significance of the problems in property insurance, see Fagin, *The Policy Implications of Predictive Decision-Making: "Likelihood" and "Dangerousness" in Civil Commitment Proceedings*, 24 PUB. POL'Y 491 (1976); Livermore, Malmquist, & Meehl, *On the Justifications for Civil Commitment*, 117 U. PA. L. REV. 75, 84 (1968).

incongruence, but involves a remaking of what the insurer may legitimately try to do; it involves a determination that an attribute of a risk will not be considered a "morally relevant characteristic."<sup>292</sup> On these questions the FIA also remains silent.

## B. Recasting the Debate

The point of this litany of reservations about the FIA proposal is not that the specific recommendations it suggests are necessarily inappropriate ways to amend the property insurance programs nor that the expedient judgments that must be made to implement its prescriptions will prove unmanageable in context; those seem difficult and still open issues, for which the cautionary questions raised here have only limited significance. Instead, the primary concern is that the FIA analysis, as an apparently authoritative statement of the public issues posed by availability problems, will continue its unfortunate tendency to channel and congeal the debate, thus limiting the issues that will be recognized and argued, and masking the fact that important questions associated with availability problems are simply not addressed by the anti-discrimination sentiment.

The problem is the familiar one featured throughout this article. Language useful to the rhetorical strategies through which political outcomes are engineered typically provides vocabularies more likely to impede than to aid clear understanding of the range of interests, attitudes and institutions implicated in complex social questions. The tensions thus imposed cannot be slipped:

Thinking clearly about goals is a tough assignment for a political system that has been held together in great part by compromise, ambiguity, and contradiction. And if a choice must be made, any reasonable person would, I think, prefer the system to the clarity. But now that we have decided to intervene in such a wide range of human affairs, perhaps we ought to reassess that particular tradeoff.<sup>293</sup>

At least the tradeoff should be confined to its own ambit; doubtless political documents may assert a claim to be understood and judged as political documents, and on that standard the FIA analysis can hardly be faulted. On the other hand, a working agenda

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292. See generally Nickel, *Discrimination and Morally Relevant Characteristics*, 32 ANALYSIS 113 (1972). For elaboration of the influence of similar themes on recent developments in constitutional equal protection doctrines and fair employment legislation, see Brest, *Foreword: In Defense of the Antidiscrimination Principle*, 90 HARV. L. REV. 1 (1976); Fiss, *Groups and the Equal Protection Clause*, 5 PHILOSOPHY & PUB. AFF. 107 (1976); Fiss, *A Theory of Fair Employment Laws*, 38 U. CHI. L. REV. 235 (1971).

293. Wilson, *supra* note 25, at 9.

for public attitudes toward availability problems should aspire to more.

A serious attempt to describe availability problems and prescribe for them could, it seems, admit the impossibility of constructing a single rubric able to summarize and rationalize the diverse claims for public interventions in insurance markets to assure availability of particular coverages, accuracy and particularization in rating, affordability, spread, maintenance of competitive balance, normalcy of operating procedures, and all of the other demands—themselves labels that simultaneously express and mask a variety of interests, attitudes, and perceptions—that may be associated with “availability problems.” “Equity” is probably as close to a universal solvent for the social concerns involved here as we are likely to create, and it is inadequate. There is not one availability problem, but many, and a single response must include a rejection or partial frustration of some of the demands being made. If the debate about the future course of public measures in this area is to be a useful one, it should confront this reality. A starting point for this process would involve, at a minimum, an attempt to disaggregate the present debate to enforce a focus on the several different claims being asserted.

This effort should also include an attempt to escape the canalizing influence of the institutional perspective that sees availability problems as necessarily “regulatory,” to be addressed if at all with the traditional array of “regulatory” responses.<sup>294</sup> If public inter-

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294. Thus, as Professor Kimball warned in 1961, “[i]f socialization of risk is viewed as an objective of insurance regulation, it at once alters the basic focus of the enterprise from one essentially private (albeit subject to control in the public interest) to one which is essentially public.” Kimball, *supra* note 1, at 513. Much of the history with which this article has dealt concerns attempts to escape that reality. A more mature formulation would recognize that the pressures lumped together in “availability problems” involve both claims for “socialization” of some risks, invoking one style of public intervention and corresponding arenas of political struggle, and more traditional claims for regulatory interventions to attempt to proscribe specific kinds of insurer conduct. See generally authorities cited note 16 *supra*; Lowi, *Decision Making vs. Policy Making: Toward an Antidote for Technocracy*, 30 PUB. ADM. REV. 314 (1970). See also K. BOULDING, *PRINCIPLES OF ECONOMIC POLICY* 300 (1958) (distinguishing regulatory interventions “politicizing” economic activity from interventions with “socializing” effects); Fuller, *Some Reflections on Legal & Economic Freedoms—A Review of Robert L. Hale’s “Freedom through Law,”* 54 COLUM. L. REV. 70 (1954) (distinguishing different “modes, forms and purposes of legal and economic restraints”):

[W]e will get along better if we do one thing at a time and by the methods appropriate to the job at hand. . . . Discretion, in the sense of proceeding with only the guidance of general standards, may be useful when applied to some problems

vention is required it can be framed as attempts to constrain, directly or indirectly, the ways in which underwriting prerogatives are exercised, but there is another choice as well. The debate should at least be broad enough to acknowledge that for some circumstances the appropriate public response may be an attempt to assure coverage for some of the risks rejected by the voluntary market, rather than an effort to intervene in the underwriting process to prevent the rejection. Cast in this fashion the debate can more easily confront the subsidiary questions of whether coverage guarantees should be accomplished through public or private bureaucracies.

Although recasting the debate in these ways might identify numerous issues of greater or lesser distinctness, at the least this effort should separate inquiries concerning what sorts of rating and underwriting decisions should be considered so antisocial as to warrant legal proscription from questions of what packages of coverages, services and price should be guaranteed to what categories of risks rejected by the voluntary market. The first set of questions implicates concerns for accuracy and particularization and the theoretical and practical limitations that must qualify pursuit of those ambitions. It also may involve demands—first felt in property insurance as objections to the use of “area” or “environmental hazards” as underwriting indicators—that a variety of decision bases be proscribed directly, perhaps for reasons that have little to do with the accuracy of the predictions use of such indicators may permit. The second set of questions invokes a different social calculus. Here the questions are whether, and to what extent, particular insurance coverages can claim an importance that will justify selecting them from among goods and services generally for special guarantees of availability.<sup>295</sup> Hopefully, the history recounted by this article suggests how the failure to keep these questions distinct may

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of corrective justice, but dangerous when applied to problems of distributive justice.

*Id.* at 80-82.

295. See generally Tobin, *On Limiting the Domain of Inequity*, 13 J.L. & ECON. 263, 264 (1970) (discussing “specific egalitarianism”—“the view that certain specific scarce commodities should be distributed less unequally than the ability to pay for them,” and the instincts that tend professional economists to oppose such interventions); Posner, *supra* note 282. Cf. Grey, *Property and Need: The Welfare State and Theories of Distributive Justice*, 28 STAN. L. REV. 877, 901 (1976) (suggesting a middle ground between the “egalitarian” views of J. RAWLS, *A THEORY OF JUSTICE* (1971), and the “libertarian” tenets stated in R. NOZICK, *ANARCHY, STATE AND UTOPIA* (1974), and arguing that “this principle—that basic material needs be guaranteed by government to those who cannot meet them through their own efforts—has come to have an entrenched status as one of the fixed moral imperatives governing our political life”).

have distorted the answer supplied for each and frustrated development of a more explicit dialogue about how to approach these areas of concern.

Of course, as we also have seen, powerful structures of habit and interest are likely to resist attempts to recast the public debate in these ways. Still, it is not clear that this effort need be without effect in the real world. Conditions have changed since the property insurance programs were first instituted. The attractions to the industry of the arguments from voluntarism are less obvious now that where they can lead is more apparent, and the programs supplying medicare benefits and flood and crime coverages have provided useful additional experience with an alternative model in which the industry role is chiefly administrative and government is the primary risk taker. Moreover, the idea of directly imposed constraints on underwriting decision predicates is less unthinkable now than a few years ago. The property programs' indirect prohibition against considering "environmental hazards" has been joined in other lines of insurance by legislative and regulatory restrictions on the use of race, sex, age and a variety of other factors in underwriting decisions.<sup>296</sup> The list seems destined to grow.

In sum, one of the important current tasks of insurance regulation and those who study it is to develop and encourage deployment of a vocabulary for availability problems that will free the debate from dominance by the institutional perspective and the rhetoric of discrimination. Probably no rigorous general formulation can be constructed for this shifting congeries of concerns, but it should be possible to do better than either the recurring slogan that converts availability problems into discrimination problems or its antithesis in blandness, the industry celebration of the inevitability of tradeoffs between spread and perfect equity. Aggregated in the FIA manner, the issues sometimes appear *sui generis*, insurance regulation's own special torment; disaggregated, the separate questions may turn out to be not so different from issues being confronted in other regulatory arenas and for which a community of experience and thought may be available and worth consulting. Joining the debate at the level of a search for "plausible policies for an imperfect world"<sup>297</sup> is not likely to much reduce the difficulties of the choices to be made, but at least it might increase their staying power by improving the chances that they will be made with a clearer advertance to the interests and attitudes that generate and shape the many facets of property insurance availability problems.

296. See note 72 *supra*.

297. Baumol, *Reasonable Rules for Rate Regulation: Plausible Policies for an Imperfect World*, in A. Phillips & O. Williamson, *supra* note 57, at 108.